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Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1986

LEROY FRANTZ, JR. and SHELIA FRANTZ,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. Whether the constitutional doctrine of separation of powers was violated by the Tax Court's judicial amendment of 26 U.S.C. § 165(c)(2) when the Tax Court overruled over 50 years of its own precedent and other court decisions of long standing consistently interpreting that section, and that section had been consistently reenacted many times by Congress, unchanged, with presumptive knowledge of the existing court interpretations and with knowledge of 35 years of published Treasury Department acquiescences in the Tax Court precedent.

2. Whether the present conflict over the meaning of 26 U.S.C. § 165(c)(2) between Circuits in the decision below, *Frantz v. Commissioner,* 784 F.2d 119 (2d Cir. 1986), and *Fink v. Commissioner,* 789 F.2d 427 (6th Cir. 1986), *rev'g* T.C. Memo. 1984-418, should be resolved in the interest of judicial harmony and impartial national administration of the tax laws.

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No.

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October Term, 1986

LEROY FRANTZ, JR. and SHEILA FRANTZ,

Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit reported at 784 F.2d 119 (2d Cir. 1986) is printed in Appendix B at 3a. The opinion of the United States Tax Court reported at 83 T.C. 162 is printed in Appendix C at 23a.

JURISDICTION

The judgment of the United States Court of Appeals for the Second Circuit was entered on February 19, 1986. A timely petition for rehearing was denied on April 8, 1986 (Appendix A at 1a). The jurisdiction of the Supreme Court is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

26 U.S.C § 165(c)(2) (Internal Revenue Code of 1954, as amended), is directly involved in both the *Frantz* and *Fink* cases. The text of § 165(a), (b) and (c) (the only parts of the statute relevant to this petition) is as follows:

> Sec. 165. Losses.
>
> (a) General Rule. — There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> (b) Amount of Deduction. — For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.
>
> (c) Limitation on Losses of Individuals. — In the case of an individual, the deduction under subsection (a) shall be limited to —
>
> (1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) except as provided in subsection (h), losses of property not connected with a trade or business if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

STATEMENT OF THE CASE

On August 7, 1984 the Tax Court decided the *Frantz* case below and the case of *Fink v. Commissioner,* 789 F.2d 427 (6th Cir. 1986), *rev'g* T.C. Memo. 1984-418. In the process the Tax Court reversed its own 55-year precedent without any independent authority. *Frantz* was decided in a regular Tax Court decision reviewed by the full court with four judges dissenting in a well reasoned opinion by Judge Parker. *Fink* was decided as a memorandum decision solely by reference to the rationale of the *Frantz* case. The issue in both cases was the same, whether a voluntary, non-prorata stock surrender results in a loss deductible currently or is a contribution to capital.

The petitioners are husband and wife and filed a joint income tax return for 1973, the year in issue. For purposes of this petition we will only refer to Leroy Frantz, Jr. (hereinafter "Frantz" or the "Taxpayer") since his wife was not directly involved in the transaction. In 1970 Frantz was a creditor of Andree Biallot, Ltd. (hereinafter "ABL" in an amount of $80,000. In 1971 Frantz converted this debt into 16,000 shares (about 11%) of ABL preferred stock pursuant to a reorganization and composition with creditors. At that time he also became a 65% common shareholder and a $50,000 note holder of ABL by reason of his investment of $200,000 in ABL. During 1971 and 1972 Frantz made additional advances to ABL in amounts of approximately $160,000. Despite

the efforts of Frantz and others involved in ABL the business did not progress as anticipated. The constant losses made ABL an unattractive investment based on its financial statements. In the hope that outside financial and marketing assistance would make the businese successful, the ABL board of directors in 1973 accepted Frantz's surrender directly to ABL of all his preferred stock and advances. He relinquished all rights to these property rights in order to improve the balance sheet and attract prospective outside investments of new equity. No other creditor or shareholder, preferred or common, joined in the surrender, which was considered non-prorata for tax purposes. Taxpayer did not receive any consideration for the surrender-transfer, and, therefore, the transaction was not an exchange for tax purposes.

Taxpayer claimed an ordinary loss under 26 U.S.C. § 165(c)(2) and (3) for tax purposes in an amount equal to the cost or basis of the preferred stock and advances surrendered. Although this loss treatment had been consistently allowed by the Tax Court for about 55 years and approved publicly for 35 years by the Commissioner, the disallowance of the ordinary loss by the Commissioner was approved by the Tax Court and affirmed by the Second Circuit.

REASONS FOR GRANTING WRIT

I.

THE DECISION BELOW SHOULD BE REVIEWED BECAUSE IT VIOLATED THE DOCTRINE OF SEPARATION OF POWERS BY JUDICIALLY AMENDING AN ACT OF CONGRESS.

The decision below altered the settled meaning of 26 U.S.C. § 165(c)(2) which had been consistently applied for 55 years in the Tax Court and its predecessor, the Board of Tax Appeals. The section allowing recognition of loss substantially as set forth in the present § 165(c)(2) first appeared in the Revenue Act of 1918. Essentially it had been held that a voluntary, non-prorata surrender of stock to the issuing corporation entitled the surrendering shareholder to an immediate, ordinary loss.

The idea of congressional adoption of judicial interpretation and administrative interpretation of statutes has been recognized in appropriate cases. It should have been applied by the Court of Appeals for the Second Circuit in the decision below to prevent the arbitrary rejection of sound, long standing judicial and administrative interpretations.

The effect of the 36-year period of public acquiescence by the Commissioner from 1941 through 1977 should not have been overlooked below. *See National Lead Co. v. United States*, 252 U.S. 140, 147 (1920). (Where statute was reenacted four times without substantial change and executive had administered it a certain way, the court interpreted the statute accordingly. "Congress is presumed to have legislated with knowledge of such an established usage of an executive department of the government.")

Moreover, the effect of the many judicial decisions interpreting the statute for over 50 years, during which time the Congress repeatedly reenacted the section involved without change was not considered. *See Lorillard v. Pons*, 434 U.S. 575, 580 (1978). (Congress is presumed to be aware of an administrative or judicial interpretation when it re-enacts a statute without change.) *Fink* relied on both the judicial and executive practices in refusing to let the Tax Court reinterpret the statute involved in this case and in *Fink*. *See Fink* at 433. (Congress is presumed to be aware of executive and judicial gloss given to certain language and thus adopts the existing interpretation unless it affirmatively acts to change the meaning.)

As noted, the predecessor of 26 U.S.C. § 165(c)(2) dates back at least to the Revenue Act of 1918. After four reenactments, the section appeared without substantial change in the Revenue Act of 1928. In 1929 the Board of Tax Appeals approved loss recognition on a stock surrender in *Wright v. Commissioner*, 18 B.T.A. 471 (1929), *modified*, 47 F.2d 871 (7th Cir. 1931). *Burdick v. Commissioner*, 20 B.T.A. 742 (1930), *aff'd*, 59 F.2d 395 (3d Cir. 1932) followed *Wright*. The section was unchanged after two reenactments in 1932 and 1934. In 1935 the Second Circuit decided *Scherman v. Helvering*, 74 F.2d 742 (2d Cir. 1935) reversing the Board of Tax Appeals and permitting immediate loss recognition on a stock transfer to a corporate employee. The section was reenacted six more times without change and became Section 165(c)(2) of the Internal Revenue Code of 1954. The legislative history of the 1954 Code stated that Section 165 was not intended to change existing law. From 1954 to the present time there have been several amendments to Section 165, but no change of any substance to Section 165(c)(2).

In the years following the major 1939 tax codification, *Miller v. Commissioner*, 45 B.T.A. 292 (1941), *acq.* 1941-2 C.B. 9 and *Budd International Corp. v. Commissioner*, 45 B.T.A. 737 (1941),

acq. 1942-2 C.B. 3, rev'd on other issues, 143 F.2d 784 (3d Cir. 1944), *cert. denied,* 323 U.S. 802 (1945) were decided and acquiesced in by the Commissioner. These cases recognized immediate loss for surrenders of stock under the predecessor of Section 165(c)(2). *Estate of Foster v. Commissioner,* 9 T.C. 930 (1947), *acq.* 1948-1 C.B. 2 also recognized immediate ordinary loss on a surrender and was acquiesced in. That acquiescence has not been withdrawn although the Commissioner did withdraw his acquiescence in *Miller* and *Budd* and substituted nonacquiescences in both cases in 1977-1 C.B. 2, 36 years after the initial acquiescence in *Miller,* and 4 years after the stock surrender by Frantz. Other parts of § 165 were amended by the Revenue Act of 1945, but no change was made to § 165(c)(2). *Duell v. Commissioner,* 19 TCM 1381 (1960), a Tax Court memorandum decision, followed the *Miller* line and allowed loss on a stock surrender. In a slightly different setting, but involving the same concept, immediate loss was recognized by a shareholder on a stock transfer to a corporate employee in *Downer v. Commissioner,* 48 T.C. 86 (1957). In the Tax Reform Act of 1969 the effect of *Downer* was legislatively repealed by the enactment of § 83 (treating certain compensatory transfers of property to employees as contributions to capital). Significantly, there was no change to § 165(c)(2). In *Smith v. Commissioner,* 66 T.C. 622 (1976), *rev'd sub nom. Schleppy v. Commissioner,* 601 F.2d 196 (5th Cir. 1979) the Tax Court again upheld ordinary loss treatment for the non-prorata surrender of stock to a corporation, but was reversed on appeal in a much criticized, ill-founded decision of the Fifth Circuit.

The Tax Court ignored the Fifth Circuit's holding in *Schleppy* and followed the loss principles of *Miller* (and its line through *Smith*) for the last time in *Tilford v. Commissioner,* 75 T.C. 134 (1980), *rev'd,* 705 F.2d 828 (6th Cir. 1983). The reversal of *Tilford* was distinguishable as based on a congressional amendment in the Tax Reform Act of 1969. This distinction was recently restated

in no uncertain terms in the Sixth Circuit's decision in *Fink v. Commissioner,* 789 F.2d 427 (6th Cir. 1986), *rev'g* T.C. Memo. 1984-418 where the Sixth Circuit refused to follow the Tax Court's abandonment of the settled law on stock surrenders outside the employee compensation area.

> Our decision in *Tilford* is only applicable to section 83 transfers of property in connection with the performance of services. By enacting section 83, Congress altered the result reached in *Downer.* The legislative history of section 83 makes it clear that Congress intended to treat the transfer of stock by a shareholder to a corporate employee as a contribution of capital. Congress has not, however, altered the result reached in *Foster.* Congress is presumed to be aware of settled judicial construction and thus adopts that construction unless it affirmatively acts to change it. *See, e.g., Florida National Guard v. Federal Labor Relations Authority,* 699 F.2d 1082, 1087 (11th Cir.), *cert. denied,* 464 S.Ct. 1007 (1983). We therefore conclude that Congress intended the shareholder who engages in a non-pro rata stock surrender to have the benefit of an immediate loss.

Id. at 433.

The Tax Court has experience with the concept of congressional adoption of judicial and administrative interpretation of statute. In actuality, it is a facet of *stare decisis.* One of the best known examples in the Tax Court is the line of cases led by *J. Simpson Dean v. Commissioner,* 35 T.C. 1083 (1961), *nonacq.* 1973-2 C.B. 4. In that case, the substantive merits of which are of no moment in this matter, the Commissioner waited 12 years to publish his nonacquiescence. *Dean* was consistently

followed by the Tax Court for some 20 years in spite of widespread criticism of its rationale. The court recognized that its precedent and the administrative practice had become binding and that only the legislature could change the way in which the tax statute had been interpreted. As late as 1979 the Tax Court refused to change its prior position:

> *Dean* gave effect to the administrative practice that had existed for 48 years as of that time . . . and that practice continued thereafter for another 12 years until the Commissioner took his present position by publishing his "nonacquiescence". Moreover, although cogent theoretical arguments could be advanced both for and against the result reached in *Dean,* it has now been on the books for 18 years. Too much water has passed over the dam to warrant reexamining the situation judicially. We think that the application of the principle of *stare decisis* is peculiarly called for here, and that if a contrary result is deemed desirable the appropriate remedy should be legislative rather than judicial.

Zager v. Commissioner, 72 T.C. 1009, 1013 (1979), *aff'd,* 649 F.2d 1133 (5th Cir. 1981). As recently as 1982 the Second Circuit recognized the binding effect of judicial interpretation of the statute in a *Dean* setting. *See Baker v. Commissioner,* 677 F.2d 11, 13 (2d Cir. 1982). (Citing *Zager,* the court stated "We affirm the Tax Court's decision, thereby deferring to Congress for any revision of the *Dean* rule, in this case as well.")

It is interesting to note that the *Dean* rule as case law was never judicially discarded. It was finally changed in 1984 by the congressional enactment of § 7872 amending the Internal Revenue Code. At the present time, efforts are being made to change the

result of the *Fink* decision legislatively as part of the current tax reform program. Comments are now being received by the congressional staff.

We submit that the *Fink* decision is only susceptible to change by the legislature, and that the *Frantz* decision below was a judicial intrusion into the legislative function.

This Court has spoken to the issue. In *United States v. Byrum*, 408 U.S. 125 (1972), an estate tax case, the taxpayer argued that it was entitled to rely on a 1962 Tax Court decision interpreting a section of the Code in its favor, as several other lower courts had done:

> . . . the existence of such precedents carries weight. The holding . . . may have been relied upon . . . . Courts properly have been reluctant to depart from an interpretation of tax law which has been generally accepted when the departure could have potentially far reaching consequences. When a principle of taxation requires reexamination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

Id. at 135.

The notion of separation of powers preventing judicial amendment of statutes whose meanings are clear or well settled

was clearly articulated by this Court in *Tennessee Valley Authority v. Hill,* 437 U.S. 153 (1978). In preventing the completion of a massive dam project that was infringing on the habitat of an endangered species, this Court refused to modify earlier judicial interpretations of the statute.

> Once the meaning of an enactment is discerned . . ., the judicial process comes to an end. We do not sit as a committee of review, nor are we vested with the power of veto . . . . [T]he commitment to the separation of powers is too fundamental for us to pre-empt congressional action by judicially decreeing what accords with 'common sense and the public weal.'

Id. at 194, 195. It should be noted that the "meaning" of the enactment in the case below was arrived at over a 55-year period of time, not to mention the 35-year period during which the Commissioner himself publicly acquiesced in the judicially articulated "meaning" of the statute.

In fact, the *Fink* decision transcends substantive tax issues and rests on the notion that *stare decisis* or congressional adoption of the meaning of the statute prevented the Tax Court from sitting as a panel of review and exercising veto power:

> By enacting section 83, Congress altered the result reached in *Downer*. The legislative history of section 83 makes it clear that Congress intended to treat the transfer of stock by a shareholder to a corporate employee as a contribution of capital. Congress has not, however, altered the result reached in *Foster*. Congress is presumed to be aware of settled judicial construction and thus adopts that construction unless it affirmatively acts

to change it.

Fink, 789 F.2d at 433.

It was error for the court below to alter the meaning of the statute. It invaded the province of the legislature and violated the constitutional doctrine of separation of powers.

II.

THE DECISION BELOW SHOULD BE REVIEWED BECAUSE IT CONFLICTS DIRECTLY WITH A RECENT DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS.

There is a direct conflict in the Second and Sixth Circuits. On April 30, 1986 the Sixth Circuit handed down its decision in *Fink v. Commissioner*, 789 F.2d 427 (6th Cir. 1986), *rev'g* T.C. Memo. 1984-418. *Fink* criticized the *Frantz* decision below on two grounds: (1) that the court's interpretation of 26 U.S.C. § 165(c)(2) was incorrect, and (2) that the Tax Court no longer had the constitutional authority to repudiate its longstanding line of cases interpreting § 165 in light of the adoption and ratification by Congress of that interpretation. The *Fink* and *Frantz* cases were decided by the Tax Court on the same day and involved identical issues. In fact, the *Fink* opinion in the Tax Court did nothing more than adopt the *Frantz* opinion as its rationale.

This conflict will cause unequal administration of the tax laws in the Tax Court itself, a court of national jurisdiction. Due to its unusual precedent-following technique, a Tax Court decision in any particular case is predictable only if there is existing Supreme Court precedent. If Supreme Court precedent does not exist, then the Tax Court may be bound only by the Circuit to which an appeal will lie, and then only by precedent that is squarely in point. Other Circuit decisions are not binding. Unless clearly bound

by higher precedent, the Tax Court must decide the case on some basis of its own making. *See Jack E. Golsen v. Commissioner,* 54 T.C. 742, *aff'd,* 445 F.2d 985 (10th Cir. 1971), *cert. denied,* 404 U.S. 940 (1971). For a startling commentary on the occasional uncertainty in the Tax Court absent Supreme Court guidance, see *James C. Bradford v. Commissioner,* 60 T.C. 253, 261 (1973) (Drennen, J., dissenting opinion).

Under the existing circumstances, taxpayers residing in the Sixth Circuit will receive a loss deduction in Tax Court based on *Fink,* while those residing in the Second Circuit will not, based on *Frantz.* Taxpayers residing in the other Circuits face the possibility of chaotic uncertainty. Thus, we believe that this petition for review should be granted in the interest of uniform and fair application of the tax law.

CONCLUSION

For the reasons set forth above, a writ of certiorari should issue to review the decision below.

Respectfully submitted,

PATRICK J. CARR
Attorney for Petitioners

APPENDIX A—ORDER DENYING PETITION FOR REHEARING FILED APRIL 8, 1986

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 8th day of April one thousand nine hundred and eighty-six.

Docket No. 85-4062

LEROY FRANTZ, JR. and SHELIA FRANTZ,

Petitioners,

-v-

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the Petitioners, Leroy Frantz, Jr. and Shelia Frantz

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active

service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

s/ Elaine B. Goldsmith
Elaine B. Goldsmith
Clerk

APPENDIX B—DECISION OF COURT OF APPEALS FOR THE SECOND CIRCUIT FILED FEBRUARY 19, 1986

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 154—August 1985 Term

Argued: October 1, 1985 Decided: February 19, 1986

Docket No. 85-4062

LEROY FRANTZ, JR. and SHEILA FRANTZ,

Petitioners,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

LUMBARD, MANSFIELD and WINTER,

Circuit Judges.

Appeal from a decision of the United States Tax Court, Samuel B. Sterrett, C.J., holding that a taxpayer's non-pro-rata surrender of preferred stock to a corporation, made for the purpose of enabling the corporation to improve its financial statements and to attract outside

financing was a capital contribution rather than an ordinary loss deductible under 26 U.S.C. § 165(c)(2).

The Tax Court also held that the corporation did not qualify as a "small business corporation" under 26 U.S.C. § 1244, which would entitle the taxpayer to claim an ordinary loss to the extent of $50,000 on the taxpayer's sale of stock issued by it.

Affirmed. Judge Winter concurs in a separate opinion.

PATRICK J. CARR, Esq., New York, NY (Eagle & Fein, P.C., New York, NY, of counsel), *for Petitioners.*

DAVID PINCUS, Esq., Appellate Section, Tax Division, Department of Justice, Washington, DC (Glenn Archer, Jr., Assistant Attorney General, Tax Division, Department of Justice, Washington, DC, Fred T. Goldberg, Jr., Chief Counsel, Internal Revenue Service, Washington, DC, of counsel *for Respondent.*

MANSFIELD, *Circuit Judge*:

Leroy Frantz, Jr. and his wife Sheila Frantz (hereinafter referred to in the singular as the "taxpayer" since Mr. Frantz was the principal actor in the relevant transactions) appeal from a decision of the United States Tax

Appendix B

Court, Sterrett, C.J., entered on January 29, 1985 (reported at 83 T.C. 162), holding that their non-pro-rata surrender of their preferred stock in a closely-held corporation controlled by them, Andree Biallot, Ltd. (ABL), and their cancellation of indebtedness for advances made to ABL for the purpose of enabling it to improve its financial statements and to attract outside financing, were capital contributions rather than ordinary losses deductible under § 165(c)(2) of the Internal Revenue Code of 1954 (hereinafter I.R.C.), 26 U.S.C. § 165(c)(2).[1] The taxpayer also appeals from the Tax Court's decision that the taxpayer's common stock in ABL did not qualify under I.R.C. § 1244, 26 U.S.C. § 1244,[2] for allowance of

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1 Title 26 U.S.C. § 165 provides in pertinent part:

"SEC. 165. LOSSES.

(a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business;".

2 Title 26 U.S.C. § 1244 provided in pertinent part in the year 1973:

"§ 1244. LOSSES ON SMALL BUSINESS STOCK

(a) *General rule.*—In the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as a loss from the sale or exchange of an asset which is not a capital asset.

(b) *Maximum amount for any taxable year.*—For any taxable year the aggregate amount treated by the taxpayer by reason of this

an ordinary loss of $50,000 on sale of a small business stock. We affirm.

The material facts are not disputed. On June 30, 1971, the board of directors and shareholders of ABL, a New York corporation that had been experiencing financial difficulties in the conduct of a perfume business, adopted a plan of reorganization whereby it would offer stock pursuant to § 1244. Prior thereto ABL had issued 1,677

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section as a loss from the sale or exchange of an asset which is not a capital asset shall not exceed—

• • • • •

(2) $50,000, in the case of a husband and wife filing a joint return for such year under section 6013.

(c) *Section 1244 stock defined.*—

(1) *In general.*—For purposes of this section, the term 'section 1244 stock' means common stock in a domestic corporation, if—

(A) such corporation adopted a plan after June 30, 1958, to offer such stock for a period (ending not later than two years after the date such plan was adopted) specified in the plan,

(B) at the time such plan was adopted, such corporation was a small business corporation,

• • • • •

(2) *Small business corporation defined.*—For purposes of this section, a corporation shall be treated as a small business corporation if at the time of the adoption of the plan—

(A) the sum of—

(i) The aggregate amount which may be offered under the plan, plus

(ii) The aggregate amount of money and other property (taken into account in an amount, as of the time received by the corporation, equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liabilities to which the property was subject or which were assumed by the corporation at such time) received by the corporation after June 30, 1958, for stock, as a contribution to capital, and as paid-in surplus,

does not exceed $500,000; . . ."

shares of common stock for which it had received $219,250. During the period from September 25, 1970, to February 1, 1971, the taxpayer had made advances of $80,000 to the corporation. Under the reorganization plan 41,925 shares of new preferred stock were issued by ABL in exchange for the company's outstanding 1,677 shares of the previously-issued common. As part of the plan a composition with creditors of ABL was negotiated whereby creditors classified as "Class C" creditors exchanged their claims against it totalling $383,840 for 76,768 shares of its new preferred. As one of these participating creditors, the taxpayer received 16,000 shares of new ABL preferred stock in exchange for claims of $80,000 for prior advances to ABL.

The June 30, 1971, reorganization plan authorized ABL to issue over a two-year period 500,000 shares of its common stock with a par value of $.01 per share on the understanding that the "maximum amount to be received by the Corporation in consideration of the stock to be issued pursuant to this plan or as a contribution to capital shall be $500,000." Upon adoption of the plan 276,250 new ABL common shares were issued to the taxpayer for $150,000, of which $2,762.50 represented payment for the stock at par value and $147,237.50 payment to capital surplus. At the same time 148,750 new common shares were issued at par value ($.01 per share) to the following:

Thomas M. Biallo,
President .....85,000 shares

Patrick J. Carr,
Executive Vice President...42,500 shares

Francis X. Weston,
Treasurer .....21,250 shares

Appendix B

Thus the taxpayer was elected Chairman of the Board and became owner of 65% of ABL's outstanding common and 13% of its preferred.

During the period from June 1971 through July 1973 the taxpayer advanced approximately $208,600 to ABL, of which $50,000 represented senior indebtedness for which the taxpayer received a non-interest bearing note. The financial condition of the company, however, continued to deteriorate. As a result, on May 4, 1973, the taxpayer entered into a written agreement with ABL whereby he surrendered all of his ABL preferred stock and cancelled "all notes and accounts receivable" due him, which he contributed "to the capital of the Company". In exchange, ABL agreed to accept the taxpayer's "contribution . . . to its capital" in order to improve the company's financial statements and attract new capital from other sources. On November 9, 1973, the taxpayer entered into a similar agreement with ABL whereby he agreed to surrender "all notes and accounts receivable" due from ABL as a "contribution to . . . capital". No similar surrender of shares or forgiveness of indebtedness was made by any other ABL stockholder. Thus the taxpayer's 65% ownership of ABL's outstanding common remained unaffected by the taxpayer's contributions to capital.

On December 27, 1973, the taxpayer sold his 276,250 shares of ABL common stock for $8,000, reflecting a loss of $142,000. For the year 1973 the taxpayer claimed ordinary losses of $210,600 for the surrender of the accounts and notes receivable to ABL, $32,000 for surrender of the preferred stock, and $50,000 under § 1244 on the sale of common stock. In addition, he claimed a long-term capital loss of $92,000 on the sale of the

common stock. The Commissioner disallowed the claimed ordinary losses on the surrender of the notes, accounts receivable and preferred stock, on the ground that they represented contributions to capital. However, the taxpayer was allowed to increase the basis of the common stock by the amount of the surrendered preferred stock, notes and accounts receivable, thereby increasing the long-term deductible capital loss claimed on the sale of the common stock.

On November 26, 1979, the taxpayer filed a petition in the Tax Court for redetermination of the tax due, claiming that the surrenders to ABL of his preferred stock and earlier advances resulted in a loss "incurred in [a] transaction entered into for profit" within the meaning of I.R.C. § 165(c)(2). The Commissioner denied the material allegation that certain of the items were deductible as ordinary losses and further alleged that the taxpayer had improperly deducted $50,000 under § 1244 as an ordinary loss on the December 1973 sale of the common stock, asserting that it must be treated as a long-term capital loss.

The taxpayer continued to claim that the surrender of the preferred stock and claims arising from $158,600 in advances were deductible as ordinary losses under a line of Tax Court cases holding that a shareholder's non-pro-rata surrender of stock to his corporation or to third parties in order to benefit the corporation results in an immediately deductible ordinary loss. *Smith v. Commissioner*, 66 T.C. 622 (1976), *rev'd sub nom., Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979); *Duell v. Commissioner*, 19 T.C.M. 1381 (1960); *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947), *acq.* 1948-1 C.B. 2; *Miller v. Commissioner*, 45 B.T.A. 292 (1941), *acq.*,

1941-2 C.B. 9, *acq. revoked and nonacq. substituted*, 1977-2 C.B. 2; *Budd International Corp. v. Commissioner*, 45 B.T.A. 737 (1941), *acq.*, 1942-2 C.B. 3, *acq. revoked and nonacq. substituted*, 1977-2 C.B. 2, *rev'd on other grounds*, 143 F.2d 784 (3d Cir. 1944), *cert. denied*, 323 U.S. 802 (1945); *Clement v. Commissioner*, 30 B.T.A. 757 (1934); *City Builders Finance Co. v. Commissioner*, 21 B.T.A. 800 (1930); *Burdick, Executrix v. Commissioner*, 20 B.T.A. 742 (1930), *aff'd*, 59 F.2d 395 (3d Cir. 1932); *Wright v. Commissoner*, 18 B.T.A. 871 (1929), *modified*, 47 F.2d 871 (7th Cir. 1931); *see also Scherman v. Commissioner*, 47 F.2d 742 (2d Cir. 1935) (allowing immediate deduction for loss relating to transfer of shares to employee of the corporation); *Tilford v. Commissioner*, 75 T.C. 134 (1980), *rev'd*, 705 F.2d 828 (6th Cir.), *cert. denied*, 464 U.S. 992 (1983) (capital loss allowed on stock transfer to emp'oyee); *Downer v. Commissioner*, 48 T.C. 86 (1967) (capital loss allowed on stock transfer to employee).

The Tax Court ruled in favor of the Commissioner. Relying on recent decisions of the Fifth Circuit in *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979), and the Sixth Circuit in *Tilford v. Commissioner*, 705 F.2d 828 (6th Cir.), *cert. denied*, 464 U.S. 992 (1983), it overruled the position taken by it for more than 50 years to the effect that each sale or surrender of stock must be treated as a discrete, fragmented, divisible transaction that closes with the sale or surrender itself. Instead it adopted the view that, when a stockholder surrenders his preferred stock on a non-pro-rata basis to a corporation for the purpose of improving the company's financial statement and enhancing the value of the stockholder's retained common, the transaction does not close until sale of the

common. Under this analysis the taxpayer's surrender of the preferred stock in the present case did not result in a loss incurred in a "trade or business," I.R.C. § 165(c)(1), and was not a transaction entered into for profit within the meaning of I.R.C. § 165(c)(2), but was an "open" non-taxable transaction, the result of which, as far as gain or loss is concerned, could not be determined until the retained common stock was sold. 83 T.C. at 178-81. Accordingly the Tax Court ruled that the surrender constituted a capital contribution which would increase the basis of the taxpayer's common stock by the acquisition cost of the preferred and the amount of the surrendered notes and accounts receivable. In thus reversing its 50-year stand, the Tax Court noted that its prior position "tended to encourage a conversion of eventual capital losses into immediate ordinary losses" and amounted to a "judicial repeal of § 165(g), which treats a loss on worthless stock as a 'loss from the sale or exchange, on the last day of the taxable year, of a capital asset' " since it would be difficult to ascertain whether the surrendering taxpayer was motivated by a desire to strengthen the corporation or to convert a capital loss into an ordinary one. *Id.*, at 182.

The Tax Court further held that ABL did not qualify as a § 1244 "small business corporation" because the amount which it could receive for the common stock it issued pursuant to the plan, combined with the amounts received from its previous stock issues, totalled more than $500,000. *Id.*, at 182-86.

Four members of the Tax Court dissented from its holding that the taxpayer's surrender of the preferred stock was a capital contribution and not deductible as an ordinary loss. They reasoned that each share of stock

must be treated as a separate, fractional, divisible property unit representing rights that are lost when it is sold or surrendered and that it cannot be aggregated or unified with other retained holdings to create an "open," "unitary" transaction. *Id.*, at 188-89. Relying on this long-standing "fractional view", the dissenters believed that the stockholder's loss must therefore be recognized at the point of surrender. They would treat the loss as an ordinary one within the meaning of § 165(c)(2) because (1) the stock was originally acquired in a transaction entered into for profit, (2) the surrender did not constitute a gift because of its purpose (to enhance the value of the stockholder's retained shares), and (3) "not every disposition of a capital asset is a 'sale or exchange' so as to generate capital gain or loss." *Id.*, at 190-92.

DISCUSSION

The principal issue before us is whether a controlling stockholder's non-pro-rata surrender of his preferred stock to his closely-held corporation for the purpose of enhancing the value of his retained common stock is a capital contribution or an ordinary loss deductible immediately under I.R.C. § 165(c)(2).[3] Resolution of the issue requires review of a few basic principles.

Before a loss resulting from a transaction may be deducted the transaction must be "closed" in the sense that it is complete and no further fluctuation in value of the asset claimed to be lost can occur. *See* 5 *J. Mertens, The Law of Federal Income Taxation* § 28.15 (1980).

[3] All parties agree that a pro-rata contribution of shares by stockholders to their corporation would not be an event for loss recognition. *See Eisner v. Macomber*, 252 U.S. 189 (1920); *Commissioner v. Hadley*, 75 F.2d 445 (2d Cir. 1935).

Losses on "open" transactions, or those in which the profit sought is only attainable in the future, are not deductible until the investment is terminated. *See* I.R.C. § 263(a); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974). Payments made to further ongoing investments are not normally considered losses, but rather capital expenditures which are part of continuing investments. At the time when a transaction closes, losses sustained by the taxpayer may be deducted. *See* I.R.C. § 165(a) ("There shall be allowed as a deduction any loss sustained during the taxable year . . ."); Treas. Reg. § 1.165-1(d)(1), 26 C.F.R. 1.165-1(d)(1) (1985); *Dawn v. Commissioner*, 675 F.2d 1077 (9th Cir. 1982) (losses "sustained" when transaction is "closed and completed"); *General Securities Co. v. Commissioner*, 123 F.2d 192, 194 (10th Cir. 1941) ("no gain or loss would be realized until the stock was disposed of and a closed transaction effected").

Normally one can ascertain with reasonable precision whether a transaction is closed or open since the taxpayer's motive and actions are unambiguous, e.g., when he makes a cash sale of stock owned by him. The issue becomes more complicated, however, when the stockholder surrenders stock to a corporation he controls in order to enhance the value of other stock of the company held by him. On the one hand, the stockholder immediately loses all of the rights associated with his ownership of the surrendered stock, including voting rights and the right to dividends, a share of the corporate assets, and any future increase in the proportionate value of each surrendered share. Under one view, sometimes referred to as the "fragmented" approach, the transaction is considered to be closed if the surrendered shares are worth less than the stockholder's acquisition cost. Adopting this

approach, the taxpayer here contends that upon his surrender of his preferred stock to ABL he received nothing in return but lost his original investment. He therefore contends that his surrender of the preferred stock to the corporation should be treated as an event for loss recognition.

On the other hand, when the taxpayer's motive in surrendering his stock to the company is to benefit his remaining shares, as is the case here, the surrender in a sense represents a continuation of his original investment in the same company. *Cf.* I.R.C. § 263 (payments to increase the value of property). The surrendered shares have some value, although it may be less than the taxpayer's original cost. His surrender of the shares to the corporation, the Commissioner contends, should therefore increase the capital value of the shares retained by the taxpayer. Viewed in the light of the surrendering taxpayer's motive, it can reasonably be concluded that the original transaction remains open, at least to the extent that the surrendered stock still has value at the time it is contributed. Under this "unified" view the transaction would not close until the taxpayer disposed of his retained shares in the company. The surrender of the stock to the corporation would therefore not be considered an event for loss recognition. Instead, it would be treated in the same fashion as would the stockholder's payment of cash or transfer of property to his company to protect his interest therein, which constitutes a capital expenditure. I.R.C. § 263(a); *Commissioner v. Idaho Power Company, supra,* at 16 (1974) (property); *Perlman v. Commissioner,* 252 F.2d 890 (2d Cir. 1958) (cash); *Eskimo Pie Corp. v. Commissioner,* 4 T.C. 669, 676 (1945), *aff'd per curiam,* 153 F.2d 301 (3d Cir. 1946)

(cash); *see also* Treas. Regs. §§ 1.61-12(a) (shareholder cancellation of indebtedness by the corporation), 1.263(a)-2(f) (payments by bondholders or shareholders to corporation pursuant to agreement).

Each of the two approaches advocated by the respective parties, the "unitary" by the Commissioner and the "fragmented" by the taxpayer, raise practical and jurisprudential problems. The "unitary" treatment of the transaction might, by postponing the date for recognition of a taxpayer's loss until an indefinite future date and by treating any loss suffered by him as a capital rather than an ordinary loss, inhibit the use of stock surrenders to the corporation as a means of improving the financial condition and attractiveness to investors of an ailing enterprise. A "fragmented" treatment of the transaction, on the other hand, may go too far in the opposite direction by giving the surrendering taxpayer an undeserved and illogical tax advantage. If he were to sell or exchange his shares instead of surrendering them to the corporation, or if he were to wait until they became completely worthless, his loss would be a capital one, not fully deductible against ordinary income under the 1954 Act. I.R.C. § 1211. However, since he receives nothing for the surrender, any loss resulting from the transaction cannot be treated as a capital one resulting from a "sale" or "exchange" as those terms are used in the Act. I.R.C. §§ 165(f), 1211. The Tax Court has therefore permitted him in the past to treat the loss as an ordinary one, giving him the advantage of the more favorable treatment. This, in turn, poses the risk that the surrender method may be used for the purpose of gaining an unusual tax benefit rather than to enhance the value of the corporation. Moreover, even if the loss were to be limited to the taxpayer's original

investment less the present value of the surrendered stock, a solution which would reflect in part both the Commissioner's and the taxpayer's concerns, the parties would face the difficult practical problem in cases such as the present one (which involves a closed, non-public corporation in deteriorating financial condition) of ascertaining the value of the surrendered shares.

As indicated above, the foregoing dilemma cannot be resolved in the present case by treating the taxpayer's surrender of preferred stock to ABL as a sale or exchange, which would enable the taxpayer to take a capital loss on the difference between the cost basis of the surrendered stock and its current value, and by holding the present value of the surrendered stock to be a capital contribution. Treatment of a unilateral, non-reciprocal surrender as a "sale or exchange" would defy the ordinary meaning of those terms. *Helvering v. Flaccus Leather Co.*, 313 U.S. 249, 251 (1941); *Fairbanks v. United States*, 306 U.S. 436 (1939); *Pounds v. United States*, 372 F.2d 342, 348-51 (5th Cir. 1967); *see* Note, "*The Elements of a Section 117 'Sale or Exchange'*," 53 Colum. L. Rev. 976, 990 (1953). Although the Tax Court held in *Downer v. Commissioner*, 48 T.C. 86 (1971), that a stock transfer by a shareholder holding more than 66⅔% of the outstanding stock to an employee of the issuing corporation, designed to induce the employee to continue working for the company, gave rise to a capital loss, we are disinclined to rely upon it as a precedent here because surrenders of stock to an issuing corporation (as distinguished from transfers to third persons) have never been recognized as sales or exchanges. Moreover, the value of *Downer* as a reliable precedent has been eroded by Congress' enactment in 1969 of 26 U.S.C. § 83(h) and the

IRS's adoption of Treas. Reg. § 1.83-6(d), which require that a transfer of stock by a shareholder to a third person for services to the corporation be treated as a contribution to capital. *See Tilford v. Commissioner, supra*, Lastly, since the 65% taxpayer in the present case controlled ABL, treatment of the taxpayer's surrender of stock to it as resulting in a loss from a sale or exchange would be barred by I.R.C. § 267. That statute disallows loss deductions from sale or exchanges between related parties, which are defined to include a corporation and a person holding 50% or more of its stock. *See McWilliams v. Commissioner*, 331 U.S. 694, 699 (1947).

In any event it is questionable whether a controlling stockholder who voluntarily surrenders stock to his corporation for the purpose of strengthening it but continues his control through stock retained by him, thereby benefiting from the surrender, necessarily suffers any recognizable loss at the time of the surrender. The taxpayer in the present case, for instance, surrendered his 13% nonvoting preferred but retained his 65% voting common. The transaction may be likened to a redemption by a majority stockholder of part of his stock, which is not entitled to treatment as a sale or exchange giving rise to a gain or loss unless the redemption results in a substantial reduction in his interest in his corporation. I.R.C. § 302(b); Treas. Regs. § 1.302-2(c); *United States v. Davis*, 397 U.S. 301 (1970); Brodsky & Pincus, *The Case of the Reappearing Basis*, 34 *Taxes* 675, 675-77 (1956). Instead, the redemption price will be treated as a dividend and the basis of his surrendered shares will be added to his retained shares. Such a surrender is also similar to a pro-rata surrender because the proportionate ownership

of the taxpayer remains substantially the same, and he reaps the benefits of the contribution. *See Hadley, supra.*

In the present case several circumstances persuade us that the Tax Court properly treated the taxpayer's non-pro-rata surrender of preferred stock as a non-deductible capital expenditure. The taxpayer here, upon surrendering his 13% interest in preferred stock, retained control of ABL through his 65% voting common stock interest in that corporation. Moreover, as in *Schleppy v. Commissioner, supra*, at 198, the taxpayer's net equity in the corporation was not substantially reduced after taking into account the extent to which it was increased in value as a result of the surrender. Because the overall change in the taxpayer's interest in ABL was miniscule compared with the taxpayer's retained interest in the company, no justification exists for treating the change in value as a capital loss, much less as an ordinary one. To do so would enable a taxpayer, who acts voluntarily in making the surrender, to manipulate his holdings for tax advantages that would not be available if he sold his shares without any such interlocking of his equity interests in the corporation. The surrender was properly treated by the Tax Court as a contribution to the capital of ABL, as it had expressly been labelled by the parties at the time of the surrender. Accordingly, we affirm the Tax Court's decision with respect to the surrender of the preferred stock. Our holding in this case, however, should not be construed as governing surrenders by a stockholder of more substantial equity interests that could truly be viewed as resulting in an immediate loss.

The taxpayer's cancellation of $158,600 in prior advances to ABL presents less of a problem than that confronted with respect to the surrender of the preferred

stock. Although the taxpayer now urges that the advances be classified as "equity," they were labelled as "loans from shareholders" in ABL's books and as "advances" in a U.C.C. financing statement filed by the taxpayer. 83 T.C. at 167. Moreover, the May 4, 1973 and November 9, 1973, agreements between the taxpayer and ABL described the cancellations as a "contribution . . . to capital." *Id.*, at 169. The Tax Court noted that the Commissioner was "fully justified in treating the advances as loans." *Id.*, at 173, n.7. Accordingly, we agree with the Tax Court that the cancellations were not deductible as losses but represented contributions to the capital of ABL. *See Commissioner v. Idaho Power Company, supra*; *Perlman v. Commissioner, supra*; *Eskimo Pie Corp. v. Commissioner, supra.*

The taxpayer's remaining contention, that the Tax Court erred in holding that the taxpayer could not take an ordinary loss up to $50,000 under I.R.C. § 1244 on the December 1973 sale of the common stock of ABL at a loss of $142,000, needs little discussion. Here the deductibility of $50,000 as an ordinary loss was precluded by evidence adduced by the Commissioner demonstrating that the aggregate amount ABL could receive over the years for issuance of its stock and previous years exceeded $500,000. The company was not, therefore, a "small business corporation" as defined in I.R.C. § 1244 (c)(2)(A) and its stock was not "§ 1244" stock. *Godart v. Commissioner*, 51 T.C. 937, 944 (1969), *aff'd on other grounds*, 425 F.2d 633 (2d Cir. 1970). Moreover, if the taxpayer's contention that the $500,000 referred to in the plan included past amounts received is accepted, then the plan failed to state specifically the maximum amount to be received by it as consideration for the "Section 1244

stock" to be issued, as required by Treas. Regs. § 1.1244(c)-1(f)(1)(i). The Commissioner therefore sustained his burden of proof on the issue.[4]

The decision of the Tax Court is affirmed.

WINTER, *Circuit Judge, concurring in the result*:

My disagreement with Judge Mansfield's thoughtful opinion lies in my preference for a clear cut rule affording a degree of future certainty rather than a narrow ruling restricted to these particular facts.

The issue in this case poses a dilemma with no apparent solution that meets fully both logical and legal criteria. Judge Mansfield's opinion neatly describes this dilemma and the solutions offered by the parties. However, it declines to adopt either the position of the taxpayer—a non-pro rata surrender of stock leads to an ordinary loss—or the position of the Tax Court—such a surrender, when intended to increase the value of a taxpayer's remaining shares, is recognized (as a capital loss) only when the remaining shares are disposed of. Rather, the majority holds that there is no ordinary loss when a non-pro rata surrender of stock does not have an impact of some undefined magnitude on the taxpayer's interest in the corporation.

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[4] Taxpayer also contends that the Tax Court had no power to depart from its earlier rulings on stock surrenders, *see* cases cited *supra*. While it is true that courts should be reluctant to depart from long-standing interpretations of tax law, *see United States v. Byrum*, 408 U.S. 125, 135 (1972), the issue is one of first impression for this Court and our decision conflicts with no rule of stare decisis.

The holding thus suggests that the particular facts of this case are the key to the decision. It is, however, ambiguous as to which facts are dispositive and as to whether the effect of a surrender of stock on the taxpayer's interest in a corporation must be quantitative in the sense of dollar value surrendered or qualitative in the sense of diminution or loss of control. This ambiguity is aggravated because the Tax Court failed to make findings that were at the time irrelevant in view of existing precedent but are essential to the majority's disposition.

There are thus no findings as to the dollar value of the taxpayer's surrender or the corporation's resulting gain. Whether the dollar value is small or large, however, the taxpayer bore 100% of the loss and got at best 65% of the gain. I say "at best" because the 65/35 division almost certainly overstates the potential benefits to the taxpayer. If the corporation were to experience a modest turnaround, dividends on the remaining preferred would have first priority. The taxpayer's surrender of his preferred shares in fact ensures that he would not have shared in any gain absent the corporation's encountering outright prosperity. Moreover, the preferred stock in this case was convertible, and those conversion rights further decreased the potential for gain on the taxpayer's part. Finally, we do not know what other rights the preferred stock had which might impinge on the taxpayer's control. It is noteworthy, I believe, that others declined to surrender their preferred shares as a means of resuscitating the corporation. The majority does not seem to me to spell out why this loss is legally of no consequence or what kind of loss would lead to a different result.

However, the majority is quite right in noting that the position urged by the taxpayer enables shareholders to

utilize non-pro rata surrenders of stock to gain tax advantages not available through a sale of shares. I would respectfully add the observation that the actual dollar value of such surrenders will almost always be disproportionate to the proposed ordinary loss. If so, however, we would do everyone a favor simply by affirming on the rationale adopted by the Tax Court and thus avoid much future litigation over the magnitude of impact of particular surrenders of stock. I therefore concur in the result.

APPENDIX C—DECISION OF TAX COURT FILED AUGUST 7, 1984

83 T. C. No. 11

UNITED STATES TAX COURT

LEROY FRANTZ, JR. AND SHEILA FRANTZ, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 16188-79 Filed August 7, 1984.

Petitioner owned 65 percent of the common stock and 13 percent of the preferred stock of a corporation. He surrendered to the corporation his preferred stock and certain advances owing to him from the corporation. The surrender was non-pro rata with respect to other shareholders. Petitioner subsequently sold his common stock. *Held,* petitioner did not sustain a loss on his surrender to the corporation of his preferred stock and advances. His surrender constituted a contribution to the capital of the corporation. To the extent that our prior cases hold that a non-pro rata surrender of stock to the issuing corporation results in an ordinary loss, they are expressly overruled. *Held further,* petitioner's common stock did not qualify as "section 1244 stock," since the corporation was not a "small business corporation" as defined in sec. 1244(c)(2)(A), I.R.C. 1954. Accordingly, petitioner is not entitled to a $50,000 ordinary loss on the sale of the stock.

Patrick J. Carr, for the petitioners.

Appendix C

Leslie J. Spiegel, for the respondent.

STERRETT, *Judge.* In his notice of deficiency dated August 28, 1979, respondent determined a $78,440.97 deficiency in petitioners' Federal income tax for the year 1973. In an amendment to his answer, respondent asserted an additional deficiency in the amount of $13,249.03. After concessions by the parties, the primary issues remaining for decision are:

(1) Whether petitioner, Leroy Frantz, Jr., sustained a loss during 1973 from surrender to a corporation, of which he was a principal common shareholder, of his preferred stock in the corporation as well as certain advances previously made by him to that corporation.

(2) Whether petitioner's shares of common stock in the corporation qualified as "section 1244 stock," thereby entitling petitioners to an ordinary loss on the sale of the stock during 1973 to the extent of $50,000.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

At the time they filed their petition in this case, Leroy Frantz, Jr. and Sheila Frantz, husband and wife, resided at 89 Butternut Hollow Road, Greenwich, Connecticut. Petitioners filed a joint Federal income tax return for the taxable year 1973 with the Internal Revenue Service Center, Holtsville, New York, which was received by the Internal Revenue Service on October 8, 1974. The amounts here in dispute relate to the activities of Leroy Frantz,

Jr., and Sheila Frantz is a party to this litigation only because she filed a joint return with her husband. When used hereinafter in the singular, "petitioner" will refer to Leroy Frantz, Jr.

During 1969 through 1973, petitioner invested a substantial amount of money in eight or nine business entities.[1] Andree Biallot, Ltd. (hereinafter referred to as ABL), a corporation engaged in the business of selling perfumeries and toilet articles, was one such entity. During this same period, petitioner was not a salaried employee of any business entity, but rather devoted his time to the supervision of his investments.

ABL was organized under the laws of the State of New York and filed its certificate of incorporation on July 1, 1966. The certificate of incorporation authorized ABL to issue 4,000 shares of common stock without par value. Prior to June 30, 1971, ABL had issued 1,677 shares of common stock without par value to an aggregate of 13 shareholders. The aggregate amount received by ABL as consideration for the issuance of the 1,677 shares of common stock was at least $219,250.

From September 25, 1970 through February 1, 1971, petitioner, who was not at that time a shareholder of ABL, made advances to the corporation in the total amount of $80,000.

As of May 1971, ABL was experiencing financial difficulties and offered to its shareholders and creditors a proposed plan of reorganization and composition with creditors. Under the plan

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1. The terms "invest," "advance," "note," "account receivable," and "contribution to capital," and any derivatives thereof, as used in the findings of fact, are not intended to be dispositive of issues under consideration.

of reorganization, negotiated with old stockholders and old creditors, adopted by the board of directors at a special meeting held on June 10, 1971, and approved by the shareholders at a meeting begun on June 21, 1971 and concluded on June 30, 1971,[2] ABL authorized 500,000 shares of a new class of common stock with a par value of $.01 per share ("new common stock") and 120,000 shares of new 6-percent convertible preferred stock with a par value of $2 per share ("new preferred stock") in place of the old authorized common stock ("old common stock"). The new preferred stock was convertible into ABL's new common stock. The plan provided for each share of old common stock to be exchanged for 25 shares of new preferred stock. Thus, the 1,677 shares of previously issued and outstanding common stock were exchanged for 41,925 shares of new 6-percent convertible preferred stock.

Ancillary to the plan of reorganization was a composition with creditors. Under the composition, which was negotiated with old creditors and old stockholders, each creditor classified as a Class C creditor received shares of the new 6-percent convertible preferred stock aggregating $40 in par value for each $100 of approved claims held against ABL. Pursuant to the final composition, certain creditors' claims aggregating $383,840 in face amount were exchanged for 76,768 shares of new 6-percent convertible preferred stock.

Petitioner was a member of the group of Class C creditors. On June 21, 1971, he exchanged his $80,000 in claims against ABL for 16,000 shares of the new 6-percent convertible preferred

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2. The stipulation of facts erroneously states that the shareholders' meeting was concluded on June 30, 1981.

stock.[3] On his Federal income tax return filed for the taxable year 1971, petitioner claimed a $48,000 loss as a result of the exchange of the $80,000 advances made to ABL for the 16,000 shares of the new 6-percent preferred stock. Said loss was allowed by respondent after audit of petitioners' 1971 income tax return.[4]

There were 21 shareholders of new preferred stock in total, 8 as a result of conversion of old debt only, 9 as a result of conversion of old common stock only, and 4 as a result of conversion of old debt and old common stock combined. Petitioner did not own any of the old common stock and, accordingly, received the new preferred stock as a result of conversion of old debt only.

At the special meeting of the board of directors of ABL held on June 30, 1971, the board of directors adopted a plan to offer stock under section 1244, I.R.C. 1954. Under this plan, ABL was authorized to offer and issue 500,000 shares of common stock with par value of $.01 per share. The shares were to be issued from June 30, 1971, the date the plan was adopted, to June 29, 1973 or to the date when ABL might make a subsequent offering of any stock, whichever should occur sooner. The plan specifically provided that "[t]he maximum amount to be received by the Corporation in consideration of the stock to be issued pursuant to this plan or as a contribution to capital shall be $500,000.00."

In accordance with the terms of the reorganization and

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3. Petitioner, in his reply to respondent's amendment to his answer, admitted to said date of exchange. However, petitioner's preferred stock certificate is actually dated July 20, 1971.

4. The tax treatment of this exchange is not an issue in the instant case.

composition with creditors, petitioner agreed to invest approximately $200,000 of which no less than $150,000 could be allocated to capital and surplus and no more than $50,000 could be classified as senior indebtedness. On June 30, 1971, after adoption of the section 1244 plan, petitioner was issued 276,250 shares of new ABL common stock in exchange for a $150,000 check issued on that date, which check included payment for the stock at par value ($2,762.50) and petitioner's contribution to capital and surplus. On June 30, 1971 ABL also issued shares of common stock at $.01 par to the following individuals, who comprised, with petitioner, all of the common shareholders of ABL:

Thomas M. Biallo	85,000 shares
Patrick J. Carr	42,500 shares
Francis X. Weston	21,250 shares

Accordingly, 75,000 shares of authorized new common stock remained unissued as of the close of June 30, 1971.

At the June 30, 1971 meeting of the board, the following persons were elected to the positions set forth opposite their respective names:

Leroy Frantz, Jr.	Chairman of the Board
Thomas M. Biallo	President and Chief Executive Officer
Patrick J. Carr	Executive Vice President and Secretary
Marion Biallo	Vice President-Public Relations
Francis X. Weston	Treasurer and Assistant Secretary

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Mr. Carr was ABL's attorney from at least June 30, 1971 to December 27, 1973. Mr. Weston was ABL's accountant and, as such, prepared ABL's financial statements and corporate income tax returns.

Petitioner advanced funds to ABL as follows:

	Amount
Check #500 and note dated 6/17/71	$ 6,000
Check #508 dated 7/7/71	35,000
Check #5736 dated 2/10/72	10,000
Check #568 dated 3/15/72	6,000
Check #569 dated 3/16/72	9,000
Check #5765 dated 4/14/72	10,000
Check #5783 dated 5/4/72	15,000
Check #589 dated 6/14/72	25,000
Check #230 dated 7/24/72	20,000
Check #608 dated 9/12/72	25,000
Check #5881 dated 9/29/72	10,000
Check #618 dated 11/3/72	1,000
Check #619 dated 11/10/72	3,100
Check #622 dated 11/17/72	1,000
Check #623 dated 11/29/72	13,500
Check #651 dated 2/27/73	5,000
Check #658 dated 3/14/73	2,000
Check #664 dated 4/16/73	2,000
Check #686 dated 7/17/73	1,000
Total	$199,600

The parties agree that $41,000 of the $50,000 of senior indebtedness referred to above is represented by check #500 dated June 17, 1971 and check #508 dated July 7, 1971. The remaining $9,000 is represented by checks issued directly to Thomas M.

Biallo, individually. In exchange for the $50,000 of advances constituting senior indebtedness, petitioner received from ABL a non-interest-bearing note, due on January 1, 1974. The $50,000 of advances constituting senior indebtedness was intended by petitioner and accepted by ABL as a loan.

It is unclear whether notes or other evidences of indebtedness were ever actually prepared representing the additional advances in the total amount of $158,600. However, the additional advances were consistently reflected on ABL's books, records, and financial statements, which were prepared by Mr. Weston, as "loans from shareholders." The financial statements were distributed to shareholders quarterly or semi-annually, and none of the shareholders ever objected to the classification of the advances as "loans." Petitioner testified that the additional advances were made without a fixed rate of interest or a fixed maturity date, and there is no evidence to refute this testimony.

On November 3, 1972, petitioner and ABL entered into a security agreement, whereby petitioner was entitled to security in ABL's accounts receivables and inventory for any loan made by petitioner from time to time thereafter. Petitioner testified that the purpose for executing the security agreement was to gain control over corporate expenditures. The board was concerned about having the security agreement made a matter of public record and, accordingly, the agreement was not filed until several months later, in June 1973.

ABL's financial condition continued to deteriorate after the reorganization and composition with creditors. Cash flow shortages were frequent and serious, and regular business operations were severely hindered because of lack of funds. At a November 6, 1972 meeting of the board, petitioners stated that

additional advances to ABL were only being made against the security of accounts receivables. It was agreed that all members of the board actively would seek additional financing. At a January 4, 1973 meeting of the board, board members discussed their progress in seeking outside investors. Messrs. Biallo and Weston reviewed the accounts receivables situation and noted that all receivables had been pledged by ABL to secure recent advances by petitioner. Mr. Carr agreed to review the advances and prepare any necessary documentation. It was unanimously decided that only the minimum amount required to keep ABL operational would be expended consistent with the continuing search for a new source of capital.

The board of ABL met again on April 16, 1973 to discuss the efforts being made to attract outside capital. Mr. Carr stated that it might be necessary, in order to improve ABL's balance sheet sufficiently to facilitate a sale of the outstanding common stock to third parties, for petitioner and Mr. Biallo, as principal creditors and preferred stockholders, to contribute their preferred stock and claims as creditors to the capital of the corporation. Mr. Biallo refused to surrender his preferred stock. Petitioner, however, authorized Mr. Carr to include as part of the terms to be proposed to a potential outside investor the contribution to capital of all of his preferred stock, notes, and accounts receivables due from ABL. It was further noted that rent was 2 months in arrears. Mr. Biallo requested petitioner to advance another $2,000, and petitioner agreed to do so. Mr. Biallo agreed to pledge to petitioner as security for petitioner's advances his income tax refunds for the calendar years 1971 and 1972, and Mr. Carr agreed to prepare the necessary documentation evidencing the $2.000 advance and petitioner's contributions to capital.

On May 4, 1973 petitioner and ABL entered into an agreement

prepared by Mr. Carr whereby petitioner surrendered all of his ABL preferred stock and cancelled "all notes and accounts receivable" due to him from ABL and contributed the same "to the capital of the Company." ABL, in return, agreed to accept petitioner's "contribution * * * to its capital." The stated purpose for the contribution was to improve ABL's financial statements in order to facilitate the raising of working capital from outside sources. A similar agreement was entered on November 9, 1973, whereby petitioner agreed to surrender and ABL agreed to accept "all notes and accounts receivable" then due to petitioner from ABL as a "contribution to * * * capital." No other shareholder or creditor surrendered any stock or debt on either occasion.

At a June 7, 1973 meeting of the board of ABL petitioner noted that he had made demand upon ABL for payment of certain secured demand notes representing advances to ABL made by him since November 1972. He further noted that his demands were not honored and that he considered the corporation to be in default on its obligations to him. Petitioner stated that he wished to protect his interest and that of ABL in the inventory. Mr. Biallo stated that the landlord had commenced eviction proceedings, and the board unanimously agreed that it would be prudent to move corporate assets from the leased premises to a new location as soon as possible.

A financing statement covering all inventory and accounts receivables of ABL, together with a copy of the security agreement executed on November 3, 1972, was filed on June 12, 1973, naming ABL as the debtor and petitioner as the secured party.

At a June 15, 1973 meeting of the board the dismal financial condition of the corporation and the ongoing efforts to attract outside financing were again discussed. The decision was made,

gradually to cease operating ABL as a going concern. Petitioner pointed out that he was a secured creditor of ABL and that his security interest in all inventory and accounts receivables had been perfected by filing a financial statement. Mr. Carr acknowledged that ABL was unable to pay the secured notes and stated that petitioner was legally entitled to take possession of the inventory. In order to prevent seizure of the inventory by the landlord, petitioner announced that the inventory would be moved to an office in Connecticut. He also requested that all further collections on accounts receivables be held for his benefit.[5]

On December 27, 1973 petitioner sold his 276,250 shares of ABL common stock to Interlodge Corp. for $8,000.

At all times between June 1971 and May 4, 1973, petitioner was a 65-percent common shareholder and a 13-percent preferred shareholder of ABL. From May 5, 1973 through December 27, 1973 petitioner was a 65-percent common shareholder only.

On their joint return for 1973, petitioners claimed ordinary losses on the surrender to ABL of $210,600 of "accounts and notes receivable" and $32,000 of preferred stock. They also claimed an ordinary loss of $50,000 on the sale of ABL common stock under section 1244 and claimed the remaining $92,000 loss on the common stock as a long-term capital loss.

In his notice of deficiency to petitioners, respondent determined that petitioners' basis in the surrendered notes and

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5. We note that the record is devoid of any reference to additional advances made subsequent to the May 4, 1973 surrender of "all notes and accounts receivable" due to petitioner from ABL and prior to the above-described actions. There is no explanation in the record of the legal authority on which these actions were taken.

accounts receivables was $179,600 rather than $210,600. Respondent further determined that $9,000 of the claimed ordinary loss of $210,600 represented a nonbusiness bad debt due from Mr. Biallo and allowed the loss as a short-term capital loss. In addition, respondent determined that the claimed ordinary losses on the surrender of notes, accounts receivables, and preferred stock were not allowable, since the surrenders represented contributions to capital. Consistent with his determination that the surrenders constituted contributions to capital, respondent allowed petitioner to increase his basis in ABL common stock by his bases in the surrendered notes, accounts receivables, and ABL preferred stock.

Respondent, by an amendment to his answer, alleged that the ABL common stock sold by petitioner on December 27, 1973 was not "section 1244 stock" and, thus, petitioners are not entitled to any ordinary loss on the sale of ABL common stock.

The parties have stipulated that petitioners' basis in the surrendered preferred stock was $32,000. Petitioners now agree and have stipulated that $2,000 of the $210,600 claimed loss on the notes and accounts receivables properly was disallowed by respondent as an ordinary loss due to lack of substantiation. Petitioners do not agree that $9,000 of the $210,600 claimed loss on the notes and accounts receivables properly was disallowed as an ordinary loss. On brief, respondent states that he has no objection to a determination that the $9,000 debt was actually a debt of the corporation rather than of Mr. Biallo personally and, as such, part of the $50,000 of senior indebtedness advanced to ABL by petitioner. In the absence of any elucidating evidence on this point and in light of respondent's statement on brief, we find as a fact that the $9,000 debt was a debt of the corporation and was included in the $50,000 of senior indebtedness advanced to ABL by petitioner.

Appendix C

OPINION

Issue 1. *Surrenders of Preferred Stock and Advances.*

The first issue for decision is whether petitioner sustained a loss during 1973 from the surrenders to ABL of his preferred stock and his advances made to ABL. It is petitioner's position that the surrenders resulted in ordinary losses. It is respondent's position that the surrenders constituted nondeductible contributions to capital. On brief, the parties essentially segregate the various items surrendered into three distinct categories—(1) the advances included in the $50,000 of senior indebtedness, (2) the additional advances in the total amount of $158,600, and (3) the preferred stock. In order to respond to the arguments raised with respect to each distinct category, we will similarly segregate the items surrendered in our discussion of the first issue.

A. *Advances included in the $50,000 of senior indebtedness.*

Generally, the cancellation of a debt owed by a corporation to its shareholder-creditor to improve the financial structure of the corporation constitutes a contribution to the capital of the corporation. Sec. 1.61-12(a), Income Tax Regs.; *Perlman v. Commissioner*, 252 F.2d 890 (2d Cir. 1958), affg. 27 T.C. 755 (1957), and *Estate of Backer v. Commissioner*, T.C. Memo. 1957-47; *Lidgerwood Mfg. Co. v. Commissioner*, 229 F.2d 241 (2d Cir. 1956), affg. 22 T.C. 1152 (1954), cert. denied 351 U.S. 951 (1956); *Bratton v. Commissioner*, 217 F.2d 486 (6th Cir. 1954), remanding a Memorandum Opinion of this Court.[6] A contribution to capital is not a loss at the time it is made. However, the shareholder is not without benefit from the transaction, since

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6. See also *Boone v. Commissioner*, T.C. Memo. 1974-152.

he is entitled to add the amount of the cancelled debt to the basis of his stock in the corporation. Thus, when the shareholder subsequently sells or otherwise disposes of his stock in a taxable transaction, the upward basis adjustment either reduces any realized gain or increases any realized loss. *Perlman v. Commissioner, supra; Lidgerwood Mfg. Co. v. Commissioner, supra; Bratton v. Commissioner, supra.*

Petitioner does not dispute that his advances comprising the $50,000 of senior indebtedness were loans to ABL. He, however, seeks to avoid the general rule that shareholder forgiveness of corporate indebtedness constitutes a contribution to capital by establishing that the debt constituted a worthless business bad debt and, hence, that its surrender gave rise to an ordinary loss, presumably under section 166(a)(1).

Petitioner's position is without merit. The record is devoid of any evidence that the debt in question was uncollectible at the time surrendered. At any rate, the Second Circuit, to which appeal lies in this case, has held that a shareholder's cancellation of the corporation's debt gives rise to a nondeductible contribution to capital, rather than a bad debt deduction, even if the debt is uncollectible when cancelled. *Lidgerwood Mfg. Co. v. Commissioner, supra.* But cf. *Giblin v. Commissioner*, 227 F.2d 692 (5th Cir. 1955), revg. a Memorandum Opinion of this Court. Further, the evidence before us is wholly inadequate to support petitioner's assertion that he should be regarded as in the business of financing and otherwise promoting small businesses. That petitioner invested substantial amounts of money in eight or nine business entities during 1969 through 1973 and devoted a great deal of his time to supervising those investments simply does not, standing alone, establish that petitioner was in the business of financing and promoting corporations. Cf. *Whipple v.*

Commissioner, 373 U.S. 193 (1963); *Smith v. Commissioner*, 62 T.C. 263 (1974). Finally, we note that petitioner claimed on his Federal income tax return for 1973, and continues to assert his entitlement to, a $50,000 ordinary loss deduction under section 1244 on the sale of his ABL common stock and claimed the loss in excess of $50,000 as a long-term capital loss. Section 1244 is applicable only where the loss "would (but for this section) be treated as a loss from the sale or exchange of a capital asset." Thus, petitioner's reporting and litigating positions belie his contention that he considered himself as in the trade or business of financing and promoting small businesses and strongly indicate that he actually viewed himself as an investor. Cf. *Smith v. Commissioner, supra* at 268-269.

In view of the foregoing, we conclude that petitioner's surrender of his advances comprising the $50,000 of senior indebtedness was a contribution to capital. Hence, we hold that petitioner is not entitled to an ordinary loss on the surrender. Instead, he must add the amount of the cancelled debt to the basis of his ABL common stock.

B. *Additional advances in the total amount of $158,600.*

Respondent essentially maintains that the result we have reached with respect to the surrender of the advances constituting senior indebtedness equally pertains to petitioner's surrender of the additional advances in the total amount of $158,600, since these advances also constituted shareholder loans. Petitioner, on the other hand, maintains that these advances constituted an equity investment in ABL, and therefore, their surrender should be governed by this Court's long-standing position that a shareholder's non-pro rata surrender of a portion of his stock to the corporation constitutes an ordinary loss. (See discussion,

infra.) The parties have extensively argued the debt-versus-equity issue. In view of our conclusions reached below with respect to the preferred stock, we find it unnecessary to classify the advances as debt or equity, for regardless of the classification we hold that petitioner is not entitled to an ordinary loss on his surrender of the additional advances. Instead, petitioner is entitled to increase the basis in his ABL stock by his basis in the advances.[7]

C. Preferred stock.

Petitioner maintains that the surrender of his preferred stock falls squarely within numerous decisions of this Court concluding that a non-pro rata surrender of stock to the issuing corporation for no consideration does not constitute a contribution to capital, but instead may result in a deductible loss. See, e.g., *Smith v. Commissioner*, 66 T.C. 622, 628 (1976), revd. sub nom. *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979); *Estate of Foster v. Commissioner*, 9 T.C. 930, 934 (1947); *Miller v. Commissioner*, 45 B.T.A. 292, 299 (1941), acquiesced 1941-2 C.B. 9, acquiescence withdrawn and nonacquiescence substituted 1977-1 C.B. 2; *Budd International Corp. v. Commissioner*, 45 B.T.A. 737, 755-756 (1941), acquiesced 1942-2 C.B. 3, acquiescence withdrawn and nonacquiescence substituted 1977-1 C.B. 2, revd. on other grounds 143 F.2d 784 (3d Cir. 1944), cert. denied 323 U.S. 802 (1945). Respondent acknowledges the substantial weight of authority in this Court against his position that petitioner's surrender of his preferred stock constituted a contribution to capital, and although he seeks to distinguish those cases on the basis that the surrenders

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7. We note that, although many of the facts tend to contradict a bona fide indebtedness with respect to the additional advances, it appears to us that respondent, taking into account a totality of the facts, has the better argument on the issue and was fully justified in treating the advances as loans.

herein were primarily tax motivated, he ultimately urges us to reconsider our position. When given a similar opportunity in *Downer v. Commissioner*, 48 T.C. 86, 90-92 (1967), we noted the appeal of a contribution to capital theory, but declined at that time "to chart a new course." We now believe, however, that the time has come to reassess our position and to confess error if necessary. Recent appellate level disapproval of the position renders it inappropriate for us to continue to justify the position solely on the basis of its history. Accordingly, we feel constrained to reconsider our prior holdings in reaching a resolution of the case now before us.

The relevant cases fall principally into two categories, neither of which at this point can be considered in isolation from the other. The first category is comprised of cases where one or more shareholders transfer stock to a third party for the benefit of the corporation, such as the transferee's promise to perform future services for the corporation or the transferee's promise to extend a loan to the corporation. We have consistently held that such a transfer may give rise to a deductible loss and have specifically rejected a contribution to capital result. See, e.g., *Tilford v. Commissioner*, 75 T.C. 134 (1980), revd. 705 F.2d 828 (6th Cir. 1983), cert. denied 464 ____ U.S. (Nov. 28, 1983); *Downer v. Commissioner, supra; Sack v. Commissioner*, 33 T.C. 805 (1960); *Clement v. Commissioner*, 30 B.T.A. 757 (1934); *City Builders Finance Co. v. Commissioner*, 21 B.T.A. 800 (1930); *Burdick, Executrix v. Commissioner*, 20 B.T.A. 742 (1930), affd. on other grounds 59 F.2d 395 (3d Cir. 1932); *Wright v. Commissioner*, 18 B.T.A. 471 (1929), modified 47 F.2d 871 (7th Cir. 1931). We have further held that such a transfer to a third party involves a "sale or exchange" and, hence, that any loss sustained is capital in nature. *Downer v. Commissioner, supra* at 92-94. The measure of that loss, where nontangible benefits incapable of independent

valuation are received by the transferor-shareholder, is the difference between the shareholder's adjusted basis in the shares and their fair market value at the time of the transfer. *Downer v. Commissioner, supra* at 94.[8]

The instant case falls into the second category of cases, where one or more shareholders disproportionately surrender a portion of their stock to the issuing corporation rather than to a third party.[9] We have consistently held that such a transfer may give rise to a deductible loss and have specifically rejected a contribution to capital result. See, e.g., *Smith v. Commissioner, supra; Estate of Foster v. Commissioner, supra; Miller v. Commissioner, supra; Budd International Corp. v. Commissioner, supra.*[10] We have

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8. In *Peabody Coal Co. v. United States,* 8 F.Supp. 845 (Ct. Cl. 1934), the Court of Claims similarly allowed a loss on a stock transfer to a third party for the benefit of the corporation. However, the court held that the amount of the loss was the full cost of the stock surrendered.

9. Where all of the stockholders surrender a portion of their stockholdings on a pro rata basis we have determined that a nontaxable contribution to capital results. See, e.g., *Bed Rock Petroleum Co. v. Commissioner,* 29 B.T.A. 118 (1933); *Haft v. Commissioner,* 20 B.T.A. 431, 436-437 (1930); *Scoville v. Commissioner,* 18 B.T.A. 261 (1929).

10. See also *Duell v. Commissioner,* T.C. Memo. 1960-248; *Payne Housing Corp. v. Commissioner,* T.C. Memo. 1954-85. But cf. *Murphy v. Commissioner,* a Memorandum Opinion of this Court dated July 28, 1945, where we concluded that to allow a loss on a disproportionate surrender to the issuing corporation would be "futile and indeed mischievious" is the amount of disproportion is slight. In *Northwest Motor Services Co. v. United States,* an unreported case (D.N.D. 1960, 5 AFTR 2d 1557, 60-2 USTC par. 9488), the district court held that an ordinary loss was allowable to a "surrendering" shareholder. However, the court's recitation of the facts is not entirely clear, and the case may have involved a transfer of stock to a third party for the benefit of the corporation.

further held that the surrender to the corporation does not constitute a "sale or exchange" and, hence, that any loss sustained is ordinary in nature. *Smith v. Commissioner, supra* at 648; *Budd International Corp. v. Commissioner, supra* at 756. The measure of that loss is the basis of the shares surrendered less the increase in book value of the shares retained by the shareholder. Any reduction in the loss is added to the shareholder's basis in his retained shares. *Estate of Foster v. Commissioner, supra* at 937; *Miller v. Commissioner, supra* at 299. But cf. *Budd International v. Commissioner, supra* at 756, where we allowed the full cost basis of the stock to be taken as a deduction.

In *Schleppy v. Commissioner,* 601 F.2d 196 (5th Cir. 1979), the Fifth Circuit reversed our decision in *Smith v. Commissioner, supra,* and held that non-pro rata surrenders of stock by two majority shareholders of slightly less than 2 percent of their stock to the issuing corporation did not give rise to deductible losses. Rather, the shareholders were required to add to the basis of their remaining shares the basis of the shares surrendered to the corporation. In rejecting our long-standing position, the Fifth Circuit referred to the holdings of this Court allowing a loss for a non-pro rata surrender of stock by a shareholder to the issuing corporation and stated: "We find no Court of Appeals decision that determines the correctness of these decisions. We therefore write on a clean sheet." 601 F.2d at 198. The court noted the general proposition that voluntary payments by a shareholder to his corporation in order to bolster its financial position constitute nondeductible contributions to capital and could see no reason why a different result should be reached if, instead of paying cash to the corporation, the shareholder surrendered part of his shares. The real difficulty that the Fifth Circuit had was in considering

the surrender transaction as a loss of any kind that would fit into the language of section 165.[11]

Notwithstanding the *Schleppy* decision, in *Tilford v. Commissioner, supra*, we based our invalidation of section 1.83-6(d), Income Tax Regs., in part, on the fact that the regulation flies in the face of our decisions holding that non-pro rata surrenders of stock do not represent capital contributions but give rise to deductible losses. 75 T.C. at 145.[12]

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11. Petitioner strongly urges that the decision in *Schleppy v. Commissioner*, 601 F.2d 196 (5th Cir. 1979), should be ignored because the Fifth Circuit so "grossly misunderstood" our decision in *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947). With all due respect to the Fifth Circuit, we also disagree with the interpretation placed by that court on our opinion in *Foster*. However, it is clear that the Fifth Circuit intended to reach a result contrary to our prior position with respect to non-pro rata surrenders of stock to the issuing corporation. We note that the Fifth Circuit arguably left unanswered whether it would find a deductible loss on the surrender of a substantial number of shares, resulting in a significant reduction in a shareholder's percentage of ownership in a corporation. Further, the court declined to endorse or criticize our decision in *Downer v. Commissioner*, 48 T.C. 86 (1967), which involved a transfer of stock to a third party in return for nontangible consideration.

12. The regulation in question provides as follows:

> (d) *Special rules for transfers by shareholders*—(1) *Transfers.* If a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor under paragraphs (a) and (b) of this section. For purposes of this (1), such a transfer will be considered to be in consideration

(Cont'd)

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The facts in *Tilford* were analogous to those in *Downer v. Commissioner, supra*, in that the taxpayer transferred stock not directly to the corporation but to corporate employees to induce them to continue work. The stock transferred in *Tilford* was subject to restrictions imposed on the transferees. The Commissioner disallowed the claimed deductions for losses on the transfers and determined that the transfers were to be treated as contributions to capital under section 1.83-6(d), Income Tax Regs. The Commissioner did not attempt to distinguish *Downer* on its facts but, in effect, argued that Congress rejected *Downer* when it adopted section 83(h) in 1969.[13] We concluded that the regulation, although based on an explicit statement in the legislative history,[14] was invalid because it exceeded the scope of the

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> for services performed for the corporation if either the property transferred is substantially nonvested at the time of transfer or an amount is includible in the gross income of the employee or independent contractor at the time of transfer under § 1.83-1(a)(1) or § 1.83-2(a). In the case of such a transfer, any money or other property paid to the shareholder for such stock shall be considered to be paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution to which section 302 applies.

13. Sec. 83(h) essentially allows a deduction under sec. 162 to the person for whom services are performed which is keyed to matching the timing of the reporting of income by the employee-recipient of restricted property.

14. The regulation is based upon the following statement in the Senate Finance Committee Report on the Tax Reform Act of 1969:

> In general, where a parent company's or a shareholder's stock is used to compensate employees under a restricted stock plan, the transfer of the stock by the parent company or

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statute itself and was contrary to our numerous decisions rejecting applicability of a contribution to capital theory with respect to stock surrenders. Following *Downer* we accordingly held that the taxpayer was entitled to capital loss deductions on the transfers of his stock.

On appeal of our decision in *Tilford*, the Sixth Circuit found the contribution to capital treatment prescribed in section 1.83-6(d), Income Tax Regs., to be consistent with both the legislative history and the statutory intent of section 83(h) to embrace a theory contrary to the one underlying the *Downer* case. The court also found support for the regulation in the Supreme Court's decisions in *Deputy v. Dupont*, 308 U.S. 488 (1940), and *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943), holding that payments made by a stockholder for the benefit of his corporation are not deductible by the stockholder. For these reasons and for the reasons "explicated * * * in *Schleppy v. Commissioner*," the Sixth Circuit held that our decision in *Tilford* was erroneous as a matter of law and hence reversed.[15]

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> shareholder is to be treated as a capital contribution to the company which is to be entitled to a deduction in accordance with the restricted property rules. The parent company or the shareholder merely is to reflect the contribution as an increase of the equity in the company which is entitled to the compensation deduction. [Tax Reform Act of 1969, S. Rept. 91-522 (1969), 1969-3 C.B. 500, 502.]

15. Although *Tilford* involved a transfer of stock to a third party, we believe that the Sixth Circuit's opinion and its reliance on *Schleppy v. Commissioner, supra,* clearly suggests that the court would also conclude that a shareholder's non-pro rata surrender of a portion of his stock directly to the issuing corporation constitutes a contribution to capital. Certainly, as a technical matter, we can

(Cont'd)

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It is in this posture that we must resolve the instant case.

The major difficulty in analyzing the transaction herein is its failure to fit neatly within any distinguishable statutory category of transactions.[16] Hence, in order to prevail, petitioner must come within the loss provisions of section 165 without the assistance of any specific statutory section that defines the surrender transaction as a loss event or deems it to be such.

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can perceive no reason why the Sixth Circuit would reach a contribution of capital result in a situation involving the transfer of restricted stock to a third party, but fail to reach such a result in a situation, such as that presented in the instant case, where stock is surrendered directly to the issuing corporation. See also *Webb v. United States*, 560 F.Supp. 150 (S.D. Miss. 1982), concluding that any excess value of stock over the amount received by shareholders from its sale to the corporation's business manager to induce him to continue to perform services for the corporation was a contribution to capital. But cf. *Scherman v. Helvering*, 74 F.2d 742 (2d Cir. 1935).

16. One commentator has suggested that the rationale, although not necessarily the mechanical tests, of section 302 should be applied to stock surrender transactions, see B. Arlinghaus, Tax Court Questions Validity of Restricted Property Regulations, 59 Taxes 261, 264 (Apr. 1981). We have considered, but rejected, the possibility of taking such an approach, as we find no authority for doing so. Further, the abuse that section 302 was intended to remedy, that is, shareholder bail-outs of corporate earnings and profits, clearly is not present in the stock surrender transaction. For additional analyses of the stock surrender transaction, see C. Johnson, Tax Models for Nonprorata Shareholder Contributions, 3 Va. Tax Review 81 (1983); G. Bolding, Non-Pro Rata Stock Surrenders: Capital Contribution, Capital Loss or Ordinary Loss?, 32 Tax Lawyer 275 (1979); L. Gebhardt, When Are Loss Deductions Available on the Voluntary Surrender of Stock?, 43 Journal of Taxation 22 (July 1975); N. O'Brien, Stock Transfers by Shareholders to Outsiders for Nontangible Consideration, 39 Taxes 675 (Aug. 1961).

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Petitioner's surrender clearly does not constitute a loss "incurred in a trade or business" within the meaning of section 165(c)(1). We have already concluded that petitioner was not in the "trade or business" of financing and promoting corporations. Further, the Supreme Court has made it clear that a corporation will not ordinarily be regarded as the alter ego of its shareholders and, hence, payments by a shareholder for the benefit of the corporation are not "incurred in a trade or business" of the shareholder. *Interstate Transit Lines v. Commissioner, supra; Deputy v. Dupont, supra.* See also *Schleppy v. Commissioner, supra; Arata v. Commissioner*, 277 F.2d 576 (2d Cir. 1960), revg. in part and affg. on this issue 31 T.C. 346 (1958). Accordingly, the crucial question is whether the surrender constitutes a loss "incurred in any transaction entered into for profit" within the meaning of section 165(c)(2).

Our earlier decisions in this area unfortunately failed to demonstrate the rationale underlying their conclusions that the surrender transaction constitutes a loss event. Recognizing a similar deficiency in the cases dealing with stock transfers to third parties, we attempted to correct it in *Downer v. Commissioner, supra* at 90-91, by justifying those decisions on a "fragmented view" of stock ownership theory. In essence, the theory is based on a recognition that the shareholder's transfer of a portion of his stock represents a final disposition of those particular shares and that such a disposition is not illusory in nature, because it results in a shift in that shareholder's proportionate interest in the corporation.

Writing for the dissent in *Downer*, Judge Drennen, echoing the views expressed in Judge Murdock's dissenting opinion in *Wright v. Commissioner, supra* at 473-474, sets forth the other side of the argument. Judge Drennen believed that the majority's

position, by allowing an immediate loss, failed to give proper recognition to the purpose of the stock transfer, and in doing so, closed a transaction that should have remained open. On the other hand, he felt that a contribution to capital result would properly recognize that the overall purpose of the stock transfer to a third party for the benefit of the corporation is to protect or enhance the value of the retained shares of stock. It is apparent from the following statement that Judge Drennen's major difficulty with our position with respect to stock transfers to third parties was the same problem the Fifth Circuit, in *Schleppy v. Commissioner, supra,* had with our position respecting stock surrenders to the issuing corporation; that is, an inability to fit the transaction within the statutory language authorizing a loss deduction:

> One example of the murkiness in decisions concerning the allowance of losses in transactions similar to this one is in pinpointing just when the "transaction entered into for profit" commenced. It would seem that it should be when petitioner originally bought the stock, with the profit motive being inferred from the mere nature of the asset purchased, because his expenditure at that time forms the basis for his loss. If such is the case we should look to the transaction here involved * * * only to determine whether there was a closed transaction with respect to the particular stock involved which gave rise to a realized loss at that time, and, if so, whether the loss was ordinary or capital in nature. If such is the proper approach, then under circumstances such as those involved here, as said by Judge Murdock, "A relationship between the stock he gives up and that he continues

to hold is thus established" and he can have no loss until he disposes of the stock he retained.

On the other hand, the cases seem to emphasize, possibly to avoid the implication that the transfer in a case like this was a gift, that the anticipated profit would arise from the increment in value of petitioner's retained stock expected to result from the services to be rendered by the recipient of petitioner's largess. This in turn suggests that the "transaction entered into for profit" was the transfer of the stock * * *. If this is true I do not think the transaction is closed until it can be determined whether the anticipated benefits will be realized, i.e., upon the sale or other disposition of petitioner's remaining stock. Otherwise it would be difficult to characterize the transfer as a "transaction entered into for profit," because if we cut it off there the transferor knows that he will suffer a loss, rather than a profit, out of this particular transaction, the loss being of his investment or basis in the stock transferred * * *. If petitioner expected * * * [the transferee's] services to increase the value of his remaining stock to the point where he could at least recover his entire investment in the corporation, then he realized no loss on the transfer. If he expected * * * [the] services to have a lesser value, then he was not entering into this transaction for a profit, but rather to avoid or reduce his losses. [48 T.C. at 95-96.]

Although the *Downer* case involved a transfer of stock to

a third party for the benefit of the corporation, we believe the two opposing views set forth therein equally are representative of the two sides of the argument in cases such as the one now before us, where the shareholder disproportionately surrenders some of his stock directly to the issuing corporation. Under the fragmentation view, the surrendering shareholder is considered to have finally disposed of the particular shares surrendered; the transaction is closed; and the shareholder is entitled to an immediate loss. Under the opposing view, the surrendering shareholder is recognized as having surrendered stock for the benefit of stock he continues to hold, thereby establishing a tie between the surrendered shares and the retained shares; the transaction remains open; and the surrendering shareholder must add the basis of the surrendered stock to the basis of the retained stock. Thus, we believe that the ultimate issue resolves itself into whether petitioner's surrender of his ABL preferred stock constituted an open or closed transaction.

In reaching a resolution of the instant case, we have carefully reconsidered the merits of the respective views. On balance we are compelled to conclude that our prior holdings that a shareholder's non-pro rata surrender of a portion of his stock to the issuing corporation constitutes a loss event were erroneous. We now believe that the considerably better view is that the surrender constitutes an open, nontaxable transaction in the nature of a contribution to capital and that the basis in the surrendered shares should be added to the retained shares. Hence, petitioner herein is not entitled to a loss on the surrender of his ABL preferred stock. Rather he must add the basis in the ABL preferred stock to the basis in his ABL common stock. This conclusion, we believe, necessarily follows from a recognition of the purpose of the transfer, that is, to bolster the financial position of ABL and, hence, to protect and make more valuable petitioner's retained shares,

and a consequent inability to fit the transaction within the statutory language authorizing a deduction for "losses incurred in any transaction entered into for profit." In other words, if we accept petitioner's alleged purpose for the surrender, we find ourselves unable to conclude that petitioner sustained a loss at the time of the transaction. To the contrary, it appears that petitioner, in surrendering his preferred stock, was attempting to decrease or avoid a loss on his overall investment. Whether petitioner would sustain a loss, and if so, the amount thereof, could only be determined when he subsequently disposed of the stock that the surrender was intended to protect and make more valuable. It would be anomalous indeed if a single act (not "netting") could qualify as a transaction entered into for profit and yet result in a recognized loss.

As previously noted, respondent attempted to distinguish our prior cases on the basis that the surrenders herein were primarily tax motivated in that petitioner was attempting to convert an eventual capital loss into an immediate ordinary loss. In view of our decision that the surrender should be treated as a contribution to capital even assuming a bona fide intent to bolster ABL's financial situation, we find it unnecessary to address respondent's attempted distinction. We note, however, that we are not unaware that our prior position tended to encourage a conversion of eventual capital losses into immediate ordinary losses. We also are not unaware that our prior position, if permitted to stand, could encourage the practical equivalent of a judicial repeal of section 165(g), which treats a loss on worthless stock as a "loss from the sale or exchange, on the last day of the taxable year, of a capital asset." As is demonstrated in our prior cases and in the instant case as well, the surrendering of stock frequently occurs in cases involving a corporation in failing financial health, where the corporation's stock has substantially declined in value.

Appendix C

Shareholders of a corporation on the verge of complete failure could, with the assistance of our prior cases, avoid the section 165(g) limitations by surrendering shares in disproportionate amounts before the stock becomes completely worthless. In such a situation it would be difficult to segregate, for purposes of disallowing the loss deduction, the desire to aid the failing corporation and protect the retained investment from the tax planning motive of converting an eventual capital loss, generally long-term in nature, into an immediate ordinary loss.[17] To perpetuate a line of authority, which we now believe is incorrect as a technical matter, seems particularly inappropriate when we consider its possible ramifications on the tax system as a whole.

In accordance with the foregoing, to the extent that our prior cases hold that a shareholder's non-pro rata surrender of a portion of his stock to the issuing corporation results in an ordinary loss, they are expressly overruled.

Issue 2. *Sale of Common Stock and Section 1244.*

The second issue for decision is whether petitioner's shares of common stock in ABL qualified as "section 1244 stock," thereby entitling petitioners to an ordinary loss on the sale of that stock during 1973 to the extent of $50,000. This issue was raised in respondent's amendment to his answer and it is, thus, one on which respondent bears the burden of proof. Rule 142(a), Tax Court Rules of Practice and Procedure.

Generally, section 1244(a) provides that a loss on section 1244 stock shall, under certain circumstances, and within specified

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17. For a further discussion of the use of the stock surrender transaction as a planning device, see L. Gebhardt, *supra* at 25-26.

limitations, be treated as an ordinary loss. Section 1244(c) sets forth a detailed definition of the term "section 1244 stock," and each requirement of that definition must be met as a condition to securing the benefits of section 1244. One such requirement is that the corporation must have been a small business corporation at the time such plan was adopted.

18 Section 1244(c)(2)(A) provides as follows:[18]

> (2) Small business corporation defined.—For purposes of this section, a corporation shall be treated as a small business corporation if at the time of the adoption of the plan—
>
> (A) the sum of—
>
> (i) the aggregate amount which may be offered under the plan, plus
>
> (ii) the aggregate amount of money and other property (taken into account in an amount, as of the time received by the corporation, equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liabilities to which the property was subject or which were assumed by the corporation at such time)

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18. Sec 1244(c) was amended by sec. 345 of Pub. L. 95-600, effective for stock issued after Nov. 6, 1978. Since the stock in question was issued on June 30, 1971, all references to sec. 1244(c) and subsections thereunder refer to that section prior to amendment. Further, regulation sections referred to are those in effect during the time in question herein.

> received by the corporation after June 30, 1958, for stock, as a contribution to capital, and as paid-in surplus,
>
> does not exceed $500,000 * * *

In addition, section 1.1244(c)-1(c), Income Tax Regs., provides, in part:

> (c) *Written plan.* (1) The common stock must be issued pursuant to a written plan * * *. The plan must specifically state, in terms of dollars, the maximum amount to be received by the corporation in consideration for the stock to be issued pursuant thereto. * * *

The facts reveal that ABL's purported section 1244 plan was adopted on June 30, 1971. Under the plan ABL was authorized to offer and issue 500,000 shares of common stock with a par value of $.01 per share. The plan specifically provided that "[t]he maximum amount to be received by the Corporation in consideration of the stock to be issued pursuant to this plan or as a contribution to capital shall be $500,000.00."

On the same day that it adopted a plan to issue section 1244 stock, ABL issued 276,250 shares of the new common stock to petitioner for $150,000 and also issued an aggregate of 148,750 shares of the new common stock to Mr. Biallo, Mr. Carr. and Mr. Weston for a total of $1,487.50. Thus, 75,000 shares of the authorized 500,000 shares of new common stock remained unissued at the close of June 30, 1971.

Prior to adopting its plan to issue section 1244 stock, ABL

had issued 1,677 shares of common stock without par value. ABL's restated certificate of incorporation executed in connection with ABL's reorganization and composition with creditors states that the total amount received by ABL on the issuance of the 1,677 shares of old common stock was $219,250.

Also prior to adopting the plan to issue section 1244 stock, ABL's board had adopted the plan of reorganization, under which the old common stock was to be exchanged for new preferred stock, as well as the composition with creditors, under which each Class C creditor was to receive shares of new preferred stock aggregating $40 in par value for each $100 of approved claims aqainst ABL. These plans were approved by ABL's shareholders at a meeting begun on June 21, 1971 and concluded on June 30, 1971, the same date on which ABL adopted its plan to issue section 1244 stock.

Respondent alleges that under these facts, ABL was not a small business corporation at the time it adopted its plan to issue section 1244 stock because at the time of the adoption of the plan the aggregate amount which could be offered under the plan ($500,000) plus the aggregate amount of money and other property (taken into account in an amount, as of the time received by the corporation, equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liabilities to which the property was subject or which were assumed by the corporation at such time) received by the corporation for stock after June 30, 1958 exceeded $500,000. Respondent asserts that both the $219,250 received by ABL for the old common stock issued prior to June 30, 1971 and the $383,840 in claims exchanged for preferred stock pursuant to the composition with creditors must be considered in determining whether ABL was a small business corporation. Petitioner, on the other hand, alleges that

the preferred stock issued pursuant to the composition with creditors was not issued physically until July 20, 1971 and, hence, that the creditors' claims exchanged for preferred stock should not be considered in determining whether ABL was a small business corporation at the time it adopted its plan to issue section 1244 stock. Petitioner further contends that even if these claims are to be taken into account, respondent has not satisfied his burden of proving ABL's basis in the claims acquired in a taxable exchange for ABL's preferred stock.

We see no need to probe into the questions raised with respect to the issuance of the preferred stock for creditors' claims, for resolution of those questions would not alter our conclusion that ABL was not a small business corporation within the meaning of section 1244(c)(2)(A). As we read ABL's alleged section 1244 plan, ABL was authorized to receive a maximum amount of $500,000 for issuance of stock pursuant to its plan. Hence, as respondent points out and under a straightforward reading of section 1244(c)(2)(A) since the aggregate amount which could have been offered under the plan alone was $500,000, ABL could not have qualified as a small business corporation at the time the plan was adopted if, between June 30, 1958 and the time the plan was adopted, even $1 had been received by ABL for stock, as a contribution to capital, or as paid-in surplus. Cf. sec. 1.1244(c)-2(d), example (1), Income Tax Regs. Yet, ABL's restated certificate of incorporationstates that ABL had received $219,250 as consideration for the issuance of the 1,677 shares of old common stock issued prior to June 30, 1971. Further, petitioner specifically admitted in his reply to respondent's amendment to his answer that he surrendered his $80,000 in creditor claims against ABL in exchange for 16,000 shares of new preferred stock on June 21, 1971, and although the value of those claims is disputed, it is clear that they were not valueless and that ABL had some basis

in the claims. Hence, since at the time it adopted its section 1244 plan, ABL had clearly received some money and property in which ABL acquired an adjusted basis and since, under ABL's plan, ABL could have received an aggregate amount of $500,000 for stock issued pursuant thereto, ABL's plan fails to fix a permissible limit on the amount that could have been received for stock issued pursuant thereto. It follows that ABL was not a small business corporation at the time it adopted its alleged section 1244 plan and consequently petitioner's common stock did not qualify as section 1244 stock.

Petitioner has not argued, except possibly by implication, that the plan's statement that "[t]he maximum amount to be received by the Corporation in consideration of the stock to be issued pursuant to this plan *or* as a contribution to capital shall be $500,000.00" (emphasis added) was intended to encompass the amounts referred to in both clause (i) and clause (ii) of section 1244(c)(2)(A). Nor would such an argument be of any avail to petitioner, because if such were the case, we would be compelled to conclude that the plan did not specifically state, in terms of dollars, the maximum amount to be received by ABL in consideration for the stock to be issued pursuant thereto as required by section 1.1244(c)-1(c)(1), Income Tax Regs., and the numerous decisions upholding the validity of that regulation. See, e.g., *Spillers v. Commissioner*, 407 F.2d 530, 533 (5th Cir. 1969), affg. a Memorandum Opinion of this Court; *Malinowski v. Commissioner*, 71 T.C. 1120, 1127 (1979); *Mogab v. Commissioner*, 70 T.C. 208, 212-213 (1978); *Siebert v. Commissioner*, 53 T.C. 1, 5 (1969); *Godart v. Commissioner*, 51 T.C. 937, 943-944 (1969), affd. 425 F.2d 633 (2d Cir. 1970); *Morgan v. Commissioner*, 46 T.C. 878, 889 (1966).

In light of our conclusion that ABL was not a small business

corporation within the meaning of section 1244(c)(2)(A), and, hence, that petitioner's common stock in ABL did not qualify as section 1244 stock, we need not address respondent's additional argument that ABL failed to comply with section 1244(c)(1)(C), which requires that no portion of a prior offering be outstanding at the time the plan was adopted.

Decision will be entered under Rule 155.

Reviewed by the Court.

DAWSON, WILBUR, CHABOT, NIMS, WHITAKER, SHIELDS, COHEN, SWIFT, JACOBS and GERBER, *JJ.*, agree with the majority opinion.

SIMPSON, KORNER, HAMBLEN, and CLAPP, *JJ.*, did not participate in the consideration of this case.

Appendix C

PARKER, *J.* dissenting in part: I cannot join the majority opinion insofar as it disallows petitioner's loss deductions for the stock he surrendered.

In 1929, a majority of the Board of Tax Appeals held that a shareholder who had surrendered some of his shares to the issuing corporation for its benefit had incurred a deductible loss. *Wright v. Commissioner*, 18 B.T.A. 471 (1929), modified on another issue, 47 F. 2d 871 (7th Cir. 1931). Until today, this Court had never wavered from its holding that a shareholder's disproportionate transfer of stock to the issuing corporation or to a third party for the benefit of the corporation is a disposition of property in which the shareholder's loss is recognized. We had so held where the transfer was directly to a third party, such as a corporate employee or creditor,[1] a view supported by other courts as well.[2] We had so held where the transfer was to the corporation as part of a plan to transfer the stock to a third party.[3] Finally, in

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1. *Burdick, Executrix v. Commissioner*, 20 B.T.A. 742 (1930) (Reviewed), affd. 59 F. 2d 395 (3d Cir. 1932); *City Builders Finance Co. v. Commissioner*, 21 B.T.A. 800 (1930) (Reviewed); *Clement v. Commissioner*, 30 B.T.A. 757 (1934) (Reviewed); *Sack v. Commissioner*, 33 T.C. 805 (1960); *Downer v. Commissioner*, 48 T.C. 86 (1967) (Reviewed); *Tilford v. Commissioner*, 75 T.C. 134 (1980) (Reviewed), revd. 705 F. 2d 828 (6th Cir. 1983), cert. denied 464 U.S. ____ (1983).

2. *Scherman v. Helvering*, 74 F. 2d 742 (2d Cir. 1935); *Berner v. United States*, 151 Ct. Cl. 128, 282 F. 2d 720 (1960); *Peabody Coal Co. v. United States*, 80 Ct. Cl. 202, 8 F. Supp. 845 (1934); *Kress v. Stanton*, 98 F. Supp. 470 (W.D. Pa. 1951), affd. per curiam 196 F. 2d 499 (3d Cir. 1952); compare *Webb v. United States*, 560 F. Supp. 150 (S.D. Miss. 1982).

3. *Wright v. Commissioner*, 18 B.T.A. 471 (1929) (Reviewed), modified on another issue 47 F. 2d 871 (7th Cir. 1931); *Budd International Corp. v. Commissioner*, 45 B.T.A. 737 (1941), revd. on other grounds 143 F. 2d 784 (3d Cir. 1944), cert. denied 323 U.S. 802 (1945); *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947) (Reviewed).

the specific context of this case, we had held that the taxpayer incurred a deductible loss where the non pro rata transfer was to the corporation for it to cancel the shares or to hold them as treasury stock.[4] I think that these decisions are sound in law and policy. Today, the majority overrules these decisions on the basis of arguments considered and rejected many times before. I dissent from the majority's abandonment of this consistent, substantial and well-reasoned body of case law.

In its zeal to prevent the perceived abuse of an ordinary loss deduction from the disposition of a capital asset, the majority misapplies the basic rules of loss recognition. Loss recognition and loss characterization are related but separate inquiries. An individual taxpayer may deduct losses incurred during the taxable year from transactions entered into for profit. Sec. 165(a), (c)(2). Essential to loss recognition is that the transaction be "closed" during the year for which the loss is claimed, fixed by identifiable events occurring in that year. Sec. 1.165-1(d)(1), Income Tax Regs.

The majority erroneously concludes that a disproportionate or non pro rata surrender of shares of stock is an "open" transaction, reasoning that the fact and amount of the shareholder's loss can be ascertained only when he has disposed of his remaining shares. When considering a claimed loss from a disposition of property, we must focus on the precise property for which the loss was claimed. The majority's open transaction analysis stands up only if the shareholder's *entire* stock investment is viewed as a single, indivisible property unit. This is the

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4. *Miller v. Commissioner*, 45 B.T.A. 292 (1941); *Smith v. Commissioner*, 66 T.C. 622 (1976), revd. sub nom. *Schleppy v. Commissioner*, 601 F. 2d 196 (5th Cir. 1979). See also *Duell v. Commissioner*, T.C. Memo. 1960-248, *Payne Housing Corp. v. Commissioner*, T.C. Memo. 1954-85.

"unitary view" of stock ownership, which until today we have always rejected. Indeed, until today the cases were uniformly to the contrary. I doubt that the majority means to suggest that a shareholder who disposes of a portion of his shares at a gain, to enhance the value of his remaining stock investments, may postpone his recognition of that gain by reducing his basis in his remaining shares.[5] Consistent application of the majority's unitary view, however, would seem to require that result.

The property disposed of in this case and for which the loss deduction was claimed was *only* the stock that petitioner had surrendered. When viewed in this light, the majority's open transaction analysis fails. This approach is the "fragmented view" or fractional view of stock ownership, which, until today, was the rule in this Court. Under the "fractional view," each individual share is a separate property unit, and absent a specific statutory provision, gain or loss is recognized on the disposition of each discrete share. Each share of stock represents a fractional ownership interest in a corporation consisting of three elements—the right to dividends, the right to assets on dissolution, and, in most cases, the right to vote in the corporation's affairs. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, sec. 14.31, pp. 14-94 to 14-95 (4th ed. 1979). When a shareholder disposes of a share of stock, those rights are lost, and his aggregate interest in the corporation in comparison to

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5. Under the now overruled cases, a surrendering shareholder has an amount realized measured by the enhanced value of his remaining shares resulting from the surrender. *Smith v. Commissioner, supra; Miller v. Commissioner, supra.* Given the numerous ways one can acquire stock, it is not implausible that a shareholder surrendering stock would have a basis in the surrendered stock of less than its present fair market value.

the interests of the other shareholders has been changed.[6] Such a change results regardless of the method and character of the stock disposition. See *Downer v. Commissioner*, 48 T.C. 86, 90-91 (1967). With a non pro rata surrender of shares to the issuing corporation, what the shareholder has after the surrender is not what he had before the surrender.

Outside of the area of stock transfers to or for the benefit of the corporation, the case law similarly reflects the fractional view of stock ownership. A shareholder disposing of stock must proceed essentially share by share; he cannot aggregate his bases and his amounts realized. *Curtis v. United States*, 336 F. 2d 714, 722 (6th Cir. 1964); *Mahaffey v. Commissioner*, 1 T.C. 176, 182-183 (1942), revd. on another issue, 140 F. 2d 879 (8th Cir. 1944). Cf. *Sicanoff Vegetable Oil Corp. v. Commissioner*, 27 T.C. 1056, 1071-1072 (1957). The tax law generally favors a fractional, divisible view of property, seeking to allocate basis and recognize gain or loss immediately when a part of a larger property is disposed of. See sec. 1.61-6(a), Income Tax Regs;[7] *Foster v.*

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6. Only where the shareholder's overall interest is unchanged because of a pro rata transfer by all shareholders of a portion of their shares does the disposition of stock constitute a nontaxable, nondeductible contribution to capital. *Bed Rock Petroleum Co. v. Commissioner*, 29 B.T.A. 118 (1933); *Haft v. Commissioner*, 20 B.T.A. 431, 436-437 (1930); *Scoville v. Commissioner*, 18 B.T.A. 261 (1929). See also *Kistler v. Burnet*, 58 F. 2d 687 (D.C. Cir. 1932), affg. *Fredericks v. Commissioner*, 21 B.T.A. 433 (1930); *Taylor v. MacLaughlin*, 30 F. Supp. 19 (E.D. Pa. 1939).

7. Section 1.61-6(a), Income Tax Regs., provides in pertinent part:

> When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained

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Appendix C

Commissioner, 80 T.C. 34, 216-217 (1983); *Fasken v. Commissioner,* 71 T.C. 650, 655-657 (1979).

The majority also suggests that the unitary view is necessary in order to find a transaction entered into for profit. In other words,the majority treats the stock surrender itself rather than the original investment in stock as the transaction entered into for profit. To avoid the conclusion that the surrender, if viewed as a closed transaction, was not profit motivated, the majority finds the requisite profit objective in the taxpayer's hope that the value of his remaining stock investment will be protected and enhanced. Whether this anticipated benefit will materialize cannot be ascertained until the disposition of the remaining shares. Hence, the majority concludes, the transaction is still open, and thus the taxpayer, as yet, has realized no loss. Again, I disagree.

Generally, the requisite profit objective for dealings in property is established (or not established) when the property is acquired. See B. Bittker, Federal Taxation of Income, Estates and Gifts, Par. 25.3 (1981).[8] The discussion of the taxpayer's

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> on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

8. Of course, losses from a transaction entered into primarily for tax benefit rather than for economic profit will not be recognized. See *Knetsch v. United States,* 172 Ct. Cl. 378, 348 F. 2d 932 (1965); *Fox v. Commissioner,* 82 T.C. ___ (filed June 25, 1984); *Smith v. Commissioner,* 78 T.C. 350 (1982). The majority, however has expressly declined to address respondent's argument that the transaction in this case was primarily tax motivated.

reasons for surrendering the stock—enhancing the value of the corporation and hence the value of his remaining shares—is to negate the Government's argument that the surrender was a gift. See *Mack v. Commissioner*, 45 B.T.A. 602 (1941), affd. 129 F. 2d 598 (2d Cir. 1942), denying the taxpayer a loss deduction on the ground that the surrender was a gift. Once the taxpayer has disproved respondent's claim that the stock surrender was for personal (not profit motivated) reasons, the profit objective of his initial stock acquisition characterizes its disposition.

Nothing in the recent reversals by the Fifth and Sixth Circuits requires the majority's abandonment of this Court's long-held "fragmented view" of stock ownership. See *Tilford v. Commissioner*, 705 F. 2d 828 (6th Cir. 1983), revg. 75 T.C. 134 (1980), cert. denied 464 U.S. ___ (1983); *Schleppy v. Commissioner*, 601 F. 2d 196 (5th Cir. 1979), revg. *Smith v. Commissioner*, 66 T.C. 622 (1976).[9] The majority states, and I agree, that the direct surrender cases and third party transfer cases must be considered together. Given this analytical framework, I find the majority's reliance upon the Fifth Circuit's *Schleppy* opinion misplaced. The majority and I both agree that the *Schleppy* court totally misread our opinion in *Estate of Foster v. Commissioner*, 9 T.C. 930 (1947).[10] The *Schleppy* court did not

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9. Barring stipulation to the contrary, this case is appealable to the Second Circuit.

10. In *Foster*, the issue was the taxpayer's basis in shares he sold during the taxable year. The amount of his basis depended upon the effect of his disposition of other shares in an earlier year. Contrary to the Fifth Circuit's reading of *Foster*, we did *not* add to the basis of the taxpayer's remaining shares the entire basis of his surrendered shares. Following *Budd International Corp. v. Commissioner, supra*, and *Miller v. Commissioner, supra*, we held that the

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consider the third party cases and the direct surrender cases together. The Fifth Circuit's attempt to distinguish *Downer v. Commissioner, supra*, as involving a transfer to a third party rather than a surrender to the corporation epitomizes its mischaracterization of the issue.[11] The Fifth Circuit suggested that after the transfer of stock to a third party, Downer had something less than what he had had before the transfer, but that in *Schleppy* the taxpayer somehow had the same interest in the corporation after the surrender of stock as he had had before the surrender. I believe this is wrong and that the error arises from an implicit reliance on a "unitary view" of a shareholder's stock investment. The Fifth Circuit also analogized Schleppy's surrender of shares of stock to a cash contribution to the corporation. Again, this disregards the fact that a cash contribution does not change a shareholder's proportionate interest in the corporation vis-a-vis

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taxpayer had suffered a deductible loss in the earlier year, and that *only* the portion of his basis in the surrendered shares that was not allowable as a loss in the earlier year was added to his basis in his remaining shares to decrease his recognized gain upon his ultimate disposition of his remaining shares during the taxable year before the Court.

11. Likewise, the Fifth Circuit's observation in *Schleppy v. Commissioner, supra*, that there were no appellate decisions in the area (601 F. 2d at 198) is questionable even when limited to stock surrenders. The Seventh Circuit affirmed our decision in *Wright v. Commissioner, supra*, involving a surrender to the corporation for reissue to a third party, holding that the taxpayer had suffered a deductible loss. The Third Circuit affirmed *Burdick, Executrix v. Commissioner, supra*, a case involving a transfer to a third party. The Court of Claims has similarly allowed a loss on a third party transfer. *Peabody Coal Co. v. United States, supra*. Other courts have allowed loss deductions in bargain sales to third parties, and these decisions are generally cited along with *Wright* and its progeny. See *Berner v. United States, supra; Scherman v. Helvering, supra; Kress v. Stanton, supra.*

the other shareholders whereas the non pro rata surrender of shares does.

I also do not read as much into the Sixth Circuit's reversal in *Tilford v. Commissioner, supra*, as does the majority. The clear focus of the Sixth Circuit's *Tilford* opinion was section 83 and section 1.83-6(d), Income Tax Regs., which that court read as legislatively changing the result in *Downer v. Commissioner, supra*. The *Tilford* court's passing reference to *Schleppy v. Commissioner, supra*, cannot be read as rejecting our "fragmented view" of stock ownership or as embracing the Fifth Circuit's implicit reliance on a "unitary view" of stock ownership. Given the Sixth Circuit's view of section 83 and the pertinent regulation, that court did not have before it the issue presented in the instant case.

At the bottom of the majority's opinion today seems to be a policy choice not to allow an ordinary loss for the disposition of a capital asset. Many of the older cases allowing the loss deductions arose before the ordinary-loss capital-loss question became relevant, but these decisions were firmly grounded in the basic rules for loss recognition. I think that it is inappropriate to warp those loss-recognition rules in the present cases merely to avoid allowing an ordinary loss deduction. Capital treatment of gain or loss on a "sale or exchange" of a capital asset is clear. Secs. 165(f), 1201-1212. However, not every disposition of a capital asset is a "sale or exchange" so as to generate capital gain or loss. See *National-Standard Co. v. Commissioner*, 80 T.C. 551 (1983). See generally B. Bittker, "Capital Gains and Losses—The 'Sale or Exchange' Requirement," 32 Hastings L.J. 743 (1981). Congress has acted many times to mandate sale or exchange treatment for various transactions,[12] and I think Congressional

12. See, e.g., secs. 165(g), 331, 1231, 1234(a), 1234A, and 1241.

action rather than judicial revision is the appropriate response in this area.

I am also unpersuaded by the majority's attempt to buttress its policy choice by its stated concern over the tax avoidance potential and the purported evisceration of section 165(g). I do not perceive in the previous cases the abuse the majority seems to find, and I am confident that traditional tax common law doctrines (substance over form, step transaction, sham, etc.) are sufficient to deal with any abuses that arise. Moreover, the taxpayer bears the burden of proving his deductible loss. *Sack v. Commissioner*, 33 T.C. 805 (1960); *Clement v. Commissioner*, 30 B.T.A. 757 (1934); Rule 142(a), Tax Court Rules of Practice and Procedure. This burden, in proper cases, would include the bonafides of his claimed motivation for the stock surrender. If a taxpayer surrenders shares with a genuine goal of preserving his corporation's existence (as opposed to an anticipatory triggering of a loss from a soon-to-be-worthless stock investment), I see no reason why, as a policy matter, an ordinary loss deduction should not be allowed

I am also troubled by the signal the majority sends as to the future of *stare decisis* in this Court. I would not reverse course at this late date. This Court staked out its position on the issue in 1929 and had consistently adhered to it until today. The arguments on each side are really no different today than they were 55 years ago. The issue raised in this case has been before the Court conference seven times.[13] Less than four years ago,

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13. See *Wright v. Commissioner, supra; Burdick, Executrix v. Commissioner, supra; City Builders Finance Co. v. Commissioner, supra; Estate of Foster v. Commissioner, supra; Downer v. Commissioner, supra; Tilford*

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in *Tilford v. Commissioner, supra*, we adhered to our consistent line of case law. We did so even though *Schleppy* had already been decided by the Fifth Circuit, and we did so even though it meant invalidating a Treasury Regulation. I see no reason to depart from *stare decisis* now.

The Fifth and Sixth Circuits have neither expressly considered nor rejected the rationale underlying our cases allowing a loss deduction. I believe that we made the correct decision in 1929, and I dissent from the majority's rejection of that decision.

FAY, GOFFE, and WILES, *JJ.*, agree with this dissent.

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v. Commissioner, supra. In *Clement v. Commissioner, supra*, we adhered to the rationale of the decisions allowing the deductible loss, but held that the taxpayer had failed to prove the amount of his loss.